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Supreme Court of the United States

OCTOBER TERM, 1957

No. 877

GRAMATAN-SULLIVAN, INC.,

Petitioner,

against

NATHAN KOSLOW,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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INDEX

	PAGE
Opinions Below	1
Jurisdiction	1
Questions Presented	2
The Statute Involved	2
Statement of the Case	3
Question Involved	4
Argument	5
APPENDIX:	
A. Opinion of U. S. Court of Appeals	1a
B. Dissent, Clark, C. J.	7a
C. Judgment of the U. S. Court of Appeals	20a

CASES CITED

Amiesite v. Luciano, 284 N. Y. 223	8
Century Indemnity Co. v. Bank of Gowanda, 265 A. D. 907	10
Danischefsky v. Klein-Watson, 209 Wsc. 210, s. c. 244 N. W. 772	6
Raymond Concrete Pile Co. v. Federation Bank, 288 N. Y. 452	6, 8
Wickes Boiler Co. v. Godfrey-Keeler Co., 2 Cir., 116 F. 2d 842	7
Wickes Boiler Co. v. Godfrey-Keeler Co., 2 Cir., 116 F. 2d 842, 121 Fed. 2d 415	8

STATUTES

New York Lien Law, §36-a	2, 4, 5
New York Lien Law, § 23	7a
New York Lien Law, § 71	3a

REPORTS

New York Law Revision Commission (1941)	
New York Law Revision Commission (1942)	6

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TO THE HONORABLE: THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The petitioner prays that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Second Circuit, entered in the above entitled case on the 7th day of January, 1957.

Opinions Below

The opinion of the District Court is reported at 143 Fed. Supp., page 642, and is printed below as 3a-16a.*

The opinion of the United States Court of Appeals, printed in Appendix A, *infra*, page 1a, is not yet officially reported.

Jurisdiction

The judgment of the United States Court of Appeals was dated and entered January 7, 1957. The jurisdiction of this court is invoked under 28 USC, Section 1254 (1).

* Figures refer to pages of the printed Appendix to appellant's brief in the United States Court of Appeals.

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Questions Presented

1. Whether Section 36-a of the Mechanic's Lien Law of the State of New York creates a trust for the benefit of all potential job creditors, or

2. Whether, on the contrary, the trust arises only to the extent of unsatisfied outstanding claims which have accrued at the moment of diversion.

The Statute Involved

Section 36-a of the Lien Law of the State of New York, reads as follows:

> "§ 36-a. Contractor who diverts funds guilty of larceny; civil remedy to enforce trust. The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement, and to the payment of premiums on surety bond or bonds filed and premiums on insurance accruing during the making of the improvement and any contractor and any officer, director or agent of any contractor who applies or consents to the application of such funds for any other purpose and fails to pay the claims hereinbefore mentioned is guilty of larceny and punishable as provided in section thirteen hundred and two of the penal law. Such trust may be enforced by civil action maintained as provided in article three-a of this chapter by any person entitled to share in the fund, whether or not he shall have filed or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improve-

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ment. For the purpose of a civil action only, the trust funds shall include the right of action upon an obligation for moneys due or to become due to a contractor, as well as moneys actually received by him. As amended L. 1942, c. 808, § 4 Eff. Sept. 1, 1942."

Statement of the Case

The petitioner is a New York corporation and in the year 1954 furnished building materials to A. Shaw & Co. Inc. on a private construction operation being erected for a corporate owner named Villa-Manor, Inc., to the total extent of $33,421.89 (of which it received nothing on account) in reliance upon a written contract between Villa-Manor, Inc. and A. Shaw & Co. Inc.; which originally called for a retained percentage of 20% until thirty days after the completion of the work but which was later secretly changed to 5%.

More importantly, petitioner relied upon the provisions of the New York State Mechanics Lien Law where, under Section 36a, moneys accruing to and paid A. Shaw & Co. Inc. by Villa-Manor, Inc. were denominated as trust funds, a diversion of which might be punished under the N. Y. Penal Law (Sec. 1302) or enforced in a civil action praying for a decree *ex maleficio* against those into whose hands the diverted trust funds passed (§ 71 MLL). This right exists in favor of job creditors as named in Section 36-a whether or not the complainant had ever filed a lien. This petitioner had filed a lien. The petitioner herein comes within the beneficent provision of the class for those for whom Section 36-a of the Mechanics Lien Law was passed.

The issue here arises because the named defendant in this proceeding, Nathan Koslow accepted a diversion of $11,900.00 of the contract proceeds on that job. He was not a job creditor, and to the extent of $11,900.00 exhausted

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the trust fund and made that amount of moneys unavailable to job creditors, including this petitioner.

Petitioner sued Nathan Koslow to have impressed a trust (§ 71 MLL) *ex malificio* on the $11,900.00 diverted to him by A. Shaw & Co., Inc., and the Southern District Court (New York) in a decision by Palmieri, D. J., sustained petitioner's claim in every respect

(1) as to the fact that the moneys were trust funds and

(2) that they were diverted to Koslow to the extent of $11,900 but

(3) limited plaintiff's recovery to $321.60 because, as the Court said, that was the amount of merchandise delivered at the time of the final act of diversion. On appeal by the petitioner-plaintiff to the United States Court of Appeals, Second Circuit, the judgment was affirmed by divided Court—Clark, C. J. writing a strong dissent.

Question Involved

Palmieri, D. J., in his opinion said: "* * * (page 6a, appendix) * * * The main question in this case is whether Section 36-a creates a trust for the benefit of all potential job claimants or whether on the contrary, the trust arises only to the extent of unsatisfied outstanding claims."

He further said (p. 6a, Appendix):

> "The scope of the limitations imposed by § 36-a on a contractor's freedom to dispose of funds due or received from an owner has not been precisely delineated by the New York Courts. * * *"

The court below in the majority opinion say (p. 4a):

> "The issue at bar does not, however, turn on whether or not the trust is for the benefit of future, as well as of existing claims; it depends upon whether

the contractor has any privilege to use the payments, pending the completion of the work, and the existence of such a privilege is not necessarily a consequence of recognizing future claimants as beneficiaries. * * *"

But the learned Chief Justice says (p. 8a):

"It is a matter of profound regret that my brethren have denigrated that source of precise and persuasive legislative history—so different from the usual confusion which such history tends to engender—which the Commission's records afford. Rather, taking some vague judicial remarks on earlier legislation, they have reacted against what is thought to be unduly harsh (more accurately, stern) measures against contractors and have fashioned a wholly original construction of the statute which substantially guts it in its immediate application here. And that, federal judges should not do to state law."

The effect of the ruling appealed from is to give a contractor an escape route from the terms of § 36-a of the New York State Mechanics Lien Law by the simple expedient of diverting funds in advance of the accrual of the claims of job creditors.

As C. J. Clarke said (p. 14a):

"My brethren nevertheless adopt a construction of the amended statute which wars with its language, its legislative history, and New York case law, and which clashes with other parts of the statutory scheme. * * *"

Argument

When we say that the issue here is one of first impression, we are supported by both the D. J. and the Judges of the Court of Appeals. Judge Palmieri derived most of the support for his decision after saying that the ques-

tion "* * * has not been precisely delineated by the New York Courts" in referring to the Wisconsin case of *Danischefsky* v. *Klein-Watson,* 209 Wsc. 210, s. c. 244 N. W. 772; while the majority here rely on *Raymond Concrete Pile Co.* v. *Federation Bank,* 288 N. Y. 452. Neither case determines the question here.

The majority cite no authority excepting the *Raymond* case, *supra,* which not only involved another section (25-a MLL)—but which was decided before the effective date of Sec. 25-a or 36-a (MLL).

That case had to be decided adversely to the plaintiff, because it had no lien, and was suing at law and not in a representative action for the benefit of others similarly situated.

Chief Justice Clark in his dissent puts it more eloquently than could the undersigned, when he says (p. 17a):

> "My brethren cite Raymond Concrete Pile Co. v. Federation Bank & Trust Co., 288 N. Y. 452, 43 N. E. 2d 486, as requiring this result. Even if that case supported the defendant's view, it would not help us here, inasmuch as the case involved the original trust fund provisions before the critical 1942 amendments. Since the opinion of the Court of Appeals was filed after the Law Review Commission completed its work, the Commission had no opportunity to say how much of that opinion remained good law after passage of the amendments."

He says further (p. 7a):

> "And the remedy is the trust device first introduced in 1929 and now perfected by legislation of 1942, drafted, nurtured, and supported with complete documentation by that most distinguished embodiment of effective law reform, the Law Revision Commission of the State of New York."

"The Commission, to end widespread uncertainty concerning interpretation of the existing provisions, recommended legislation clearing up items of doubt. The critical part of the Commission's work for purposes of this case concerned the scope of the trust fund. Thus it approved the view urged unsuccessfully by the present plaintiff—that all money paid or owing to the contractor for work on one improvement constituted a single trust res for the benefit of all those who worked on that improvement. This idea of a single trust for a single improvement permeates every page of the official report.* * *"

"The study group thus concluded that the interpretation urged by the plaintiff here was correct unless claimants were required to file notice of lien to qualify as beneficiaries. This idea had appeared in one Appellate Division case and was followed by us in our first opinion in Wickes Boiler Co. v. Godfrey-Keeler Co., 2 Cir., 116 F. 2d 842. The Commission took great pains to wipe out these two decisions which had cast doubt on what it considered the proper construction of the statute."

"The Legislature passed the amendments as requested, thus ratifying the Commission's construction of the statute and rejecting the contrary interpretation of the first Wickes Boiler Co. case."

"These amendments were the careful work of skilled draftsmen who had analyzed the prior statute and cases. They were adopted without change by the Legislature so that the Commission's consistent scheme was not marred. Introducing new wrinkles at this late date causes nothing but mischief."

"The record in the present appeal suggests that pyramiding still occurs in New York, and that persons like the plaintiff still need protection. The earlier state cases, down through the Raymond decision, did evince sufficient hostility to require the

careful corrective provisions developed so ably by the Law Revision Commission. I suggest that it is to say the least anomalous for us now to take up the cudgels for the pyramider and raise obstacles to the enlightened Commission and legislative program which have never occurred to the state courts."

The Court of Appeals Has Applied an Erroneous Standard of Construction in Reviewing Judge Palmieri's Decree

He relied upon the dictum in *Raymond Concrete Pile Co.* v. *Federation Bank,* 288 N. Y. 452 as supporting the legal proposition (p. 7a, Appendix)

> "• • • that no trust arises under § 36a of the Lien Law in the absence of unpaid claims outstanding against the contractor."

Our statement that the majority opinion is based upon the dictum of a decision (*Raymond Concrete* v. *Federation, supra*) which is not apposite is supported by its judicial history and precedents and the state of the law applicable to the facts in that case at the time of that decision. This same Federal Court of Appeals in reversing itself in *Wickes Boiler Co. Inc.* v. *Godfrey-Keeler Co.,* 121 Fed. 2nd 415 (certiorari denied 314 U. S. 686) recognizing that its previous decision in *Wickes Boiler* v. *Godfrey-Keeler* was decided on the strength of the Appellate Division decision in the case of *New York Trap Rock Corp.* v. *National Bank of Far Rockaway,* which had interpreted the Court of Appeals decision in *Amiesite* v. *Luciano,* 284 N. Y. 223 as holding that "funds received by a contractor do not assume the character of trust funds unless and until a lien is filed while the funds are in the contractor's hands," went on to say: "We had seriously doubted whether this was a holding of the New York Court of Appeals and that it was at best but a dictum and very

likely not even that. But the deliberate holding of the Appellate Division that this was the effect of the Court of Appeals decision caused us to change our own view of the proper decision on the present appeal. Since our opinion in the present case was filed, the New York Court of Appeals has reviewed the Appellate Division in *New York Trap Rock Corp.* v. *National Bank of Far Rockaway, supra*, and has affirmed its decision in the following memorandum:

"35 N. E. 2nd 498.

'New York Trap Rock Corp. et al. app. v. The National Bank of Far Rockaway, res. Judgment affirmed with costs. We agree that regardless of the construction of the scope and effect of Section 25a of the Lien Law, no action at all can be brought by a single creditor. The determination of the construction and effect of Section 25a must await a case in which such question is necessarily presented.' • • • in declining to pass on the 'construction and effect of Section 25a of the Lien Law' the New York Court of Appeals was careful to avoid approving the view expressed by the Appellate Division that funds received by a creditor 'do not acquire the character of trust funds unless and until a lien is filed while the funds are in the contractor's hands.' • • • We think that the express language of Section 25a of the Lien Law the refusal of the Court of Appeals in New York Trap Rock Corp. v. National Bank of Far Rockaway • • • to sanction the interpretation of that language adopted by the Appellate Division and the recent decision of the First Department in Raymond Concrete Pile Co. v. Federation Bank & T. Co. supra, all indicate that the claim of Wickes Boiler Co. Inc. should be allowed and the order of the court below affirmed."

The foregoing quotation shows how the Court of Appeals in 1941 was upholding the theory and intent of the legis-

lature that relief be accorded to laborers and materialmen, the necessity for which was emphasized in the report of the New York Joint Legislative Committee, later at the time referred to by Chief Judge Clark known as the Law Revision Commission of the State of New York.

As we said before and in the court below and as is stressed in the minority opinion of Chief Justice Clark, plaintiff could not recover in the *Raymond* case because it had no lien filed against the job funds; the statute allowing a job creditor to sue for its own benefit and of all others similarly situated had not yet become effective (see pp. 17, 18, Plaintiff-Appellant's Brief below). That being so, the departure by the Court of Appeals of the State of New York from the facts before it and its launching forth on an academic discussion of the trust clause has led many subordinate jurists into fatal error in the application of the law to the rights of many plaintiffs claiming under the provisions of Section 36a herein involved.

While some of the Appellate Courts of the State of New York have cast doubt upon the construction urged here we point to the case of *Century Indemnity Co.* v. *Bank of Gowanda*, 265 A. D. 907 as sustaining our argument that it is distinguishable. There we had a case where the trial court had sustained the claim that certain moneys were "trust" funds and on application for reargument (which was denied) the Court handed down a memorandum decision (all five Judges concurring) saying in part:

> "We are still of the opinion that the decision in the case of Raymond Concrete Pile Co. v. Federation Bank, 288 N. Y. 452, is not controlling in the instant case. In that case the opinion states 'as a general rule * * * a banker who knows that a fund on deposit with him is a trust fund cannot appropriate that fund for his private benefit * * * But one who relies

upon the application of those principles must always affirmatively establish that the bank had notice or knowledge not only that the moneys on deposit were for a trust purpose but also that they were diverted from that purpose.' Again the opinion states: 'It necessarily follows that no trust arises * * * from the mere fact that the contractor received and had in his hands moneys in payment on account of a public improvement,' but in the instant case, there were findings * * * supported by evidence that defendant had notice and knowledge of the fact that the moneys were trust funds and diverted to the payment of the contractor's debt to the bank. So here the District Judge has found both notice and knowledge that the moneys diverted were trust funds."

The effort of the majority to ascertain the legislative intent finds no support for such a limited construction. Had the Legislature had such restrictions in mind and in disregard of the report of the Law Revision Commission, it could have written the statutory provision as is here illustrated, *e. g.*:

> "The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the claims 'then due and owing' of subcontractors * * * etc. (Underscored matter supplied.)
>
> Such trusts may be enforced by civil action maintained as specified in Article 3-a of this chapter by any person entitled to share in the fund 'who was a creditor at the time of the diversion' whether or not he should have filed a lien or had the right to file a lien." (Underscored matter supplied.)

The New York Court of Appeals in *Edison Electric Illuminating Co.* v. *Frick Co.*, 221 New York 1, in en-

deavoring to ascertain the intent of the legislature said, among other things:

> "But clearly we ought not to thus interpret this clause by itself and wholly detached from the statute of which it is a portion. We ought to consider the origin and purpose of the entire statute; and especially we ought to consider (if they are known and open to our consideration) the origin and purpose of the particular provision which we are interpreting. (People ex rel. Collins v. Spicer, 99 N. Y. 225, 233; People ex rel. Earl v. England, 16 App. Div. 97, 100; Holy Trinity Church v. U. S. 143 U. S. 457, 463.)"

Truly the majority have, as said by Clark, C. J. (p. 310) "denigrated that source of precise and persuasive legislative history • • • substantially guts it in its immediate application here. And that federal judges should not do to state law".

The effect of the decision will be devastating in the enforcement of job creditor's rights not only in New York but elsewhere, for now the decision appealed from not only allows the respondent to retain $11,578.40 of these trust funds contrary to the intent of the Legislature, shown by the enactment of Section 36-a and 25-a of the Mechanic's Lien Law; but leaves the petitioner's $33,421.89 claim unpaid by the contractor, but more importantly for future job creditors, leaves them without a remedy.

Wherefore, this case merits the consideration of this Court, to which end this petition is

Respectfully submitted,

by Francis J. Duffy,
Counsel for Petitioner.

March 12, 1957.

Appendix

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 47—October Term, 1956.

(Argued October 9, 1956 Decided January 7, 1957.)

Docket No. 24140

GRAMATAN-SULLIVAN, INC.,

Appellant,

—v.—

NATHAN KOSLOW,

Appellee.

Before:

CLARK, *Chief Judge,*
HAND and SWAN, *Circuit Judges.*

Appeal by the plaintiff from a judgment of the District Court for the Southern District of New York (Palmieri, *J.*, presiding), in its favor for $321.60 in an action brought under section 36a of the Lien Law of New York.

FRANCIS J. DUFFY, *for the Appellant.*

RALPH STOUT, *for the Appellee.*

HAND, *Circuit Judge*:

The plaintiff, a New York corporation, appeals from a judgment in its favor, awarding a part only of its claim against the defendant, a citizen of New Jersey: the juris-

diction depends upon this "diversity" of citizenship. The plaintiff's claim arises because of an alleged diversion to the defendant of a "trust" fund which a New York corporation, A. Shaw & Co., Inc., should have held for the payment of the plaintiff's claim against it. The complaint alleged that the "trust" arose under § 36a of the Lien Law of New York because of the following facts. A. Shaw & Co., Inc., is a building contractor, and had entered into a contract to construct the masonry needed for an "improvement" upon real estate in Dobbs Ferry, New York. Although the plaintiff had no contract with the contractor, upon the contractor's orders it from time to time furnished sand and mortar needed on the job as it went along; so that, when the contractor abandoned performance of the contract at the end of August 1954, it owed the plaintiff more than $33,000. The contract provided for interim payments each month by the owner as the work progressed, two installments of which make up the fund in dispute, which the contractor received in May and June 1954, and which it turned over to the defendant in payment of loans by him for money used to finance the job. At the time of these two payments the contractor owed the plaintiff only $321.60, and it is to that amount that Judge Palmieri limited the plaintiff's recovery, instead of awarding it the whole of the two installments. He held that, although § 36a imposed a "trust" upon all payments made to a contractor, it secured subcontractors only to the extent of their claims at the time when the payments were made, and that the contractor was not therefore obliged to retain interim payments intact as a "trust" until the completion of the job. It was from this limitation of its recovery that the plaintiff appeals.

The first question is whether the contractor was an "indispensable" party, jurisdiction over which was a condition upon the validity of any judgment herein. The plaintiff made it a party defendant in the original complaint but

struck it out by amendment, because, like the plaintiff, it was a New York corporation and its presence defeated the "diversity" jurisdiction of the court. It is clear that the contractor has no personal interest in the outcome of this action, because if the plaintiff succeeded, the payments made by the defendant would *pro tanto* reduce its debt to the plaintiff and it would at most revive the defendant's claim against it, thus merely changing one creditor for another. Ordinarily, "indispensable" parties are those whose presence is necessary to protect them from injustice to them that will arise out of the judgment. The defendant does not press that objection here; instead he argues that it is he, and not the contractor, who would have been prejudiced by a full recovery, because although that would revive his debt against the contractor, in an action to collect it, he would not have the benefit of an estoppel upon the issue whether the payments had been made out of interim payments by the owner. It is impossible to take this argument seriously as a basis for holding that the court was without jurisdiction to decide the action at bar. In an action by the defendant to collect his debt against the contractor, it is the contractor which would have the burden of proving the payments, which were in fact made by endorsing to the defendant cheques of the owner. Certainly, as soon as that appeared, it became evident that the defendant could be under no handicap upon meeting a defense that the contractor had paid its debt out of funds not derived from the owner. We agree, therefore, that the court had jurisdiction under Rule 19(b) to proceed without the presence of the contractor, and we reach the merits.

The plaintiff's position is that § 36(a) makes all interim payments on a building job a trust fund, not only for the benefit of existing claims of "subcontractors," but of future claims that may arise thereafter as the work progresses. The contractor must keep intact all such payments save that he may pay claims of other "subcontractors" as they fall

due. If he uses the payments for any other purpose, he is guilty of larceny, and anyone who receives them is liable, at least civilly to "subcontractors," present and future, if he knows, or is charged with notice, that what he receives is part of an interim payment. For this interpretation the plaintiff especially relies upon a report of the New York Law Revision Commission, submitted to the legislature on December 11, 1941, which presumably resulted in the amendment of § 36(a) and which for the first time expressly granted a civil remedy for breaches of the trust. This report did indeed twice say that "it would seem" that the trust was for the benefit of future, as well as existing, claimants; and, although such a guarded statement was not a categorical ruling, but apparently tentative, we will assume *arguendo* that it is authoritative. The issue at bar does not, however, turn on whether or not the trust is for the benefit of future, as well as of existing, claims; it depends upon whether the contractor has any privilege to use the payments, pending the completion of the work, and the existence of such a privilege is not necessarily a consequence of recognizing future claimants as beneficiaries. The privilege to pay claims as they mature, itself shows that the trust is not of the usual kind, for its exercise may result in giving earlier claimants a preference over later: e. g. if the contractor fails to earn any later payments. However, that privilege would not justify a privilege to use the payments for the contractor's own purposes, had not the section declared that a contractor is guilty of larceny, if he not only fails to apply the payments to "the claims of subcontractors" but that he also "fails to pay the claims." In short, if he pays the claims from other resources, he is not guilty of larceny, though he has used the payments for other purposes. It is a necessary condition upon his guilt that he shall be in default in the payment of the claims and it follows that he cannot be guilty as to claims that have not matured—certainly not as to claims

not yet even in existence. No doubt, that exposes "subcontractors" to the risk of the contractor's continued solvency before their claims mature, but it does not deny them protection as soon as they do. Moreover, this does not appear to us an unreasonable compromise between the possible necessities of the contractor, and the protection of "subcontractors" considering the fact that a criminal sanction was being imposed.

At any rate, whether or not as a new proposition that is the correct interpretation of the language, the Court of Appeals adopted it in *Raymond Concrete Pile Co.* v. *Federation Bank,* 288 N. Y. 452. When that case was in the Appellate Division (261 App. Div. 25), the critical issue was that "[R]easonable inquiry on the part of the bank undoubtedly would have disclosed the fact that L. P. O'Connor, Inc., would be unable to pay its subcontractors on February twentieth, if, as was done in this case, the sum of $78,000 was deducted from the face amount of the check" received from the owner (p. 28). However, in the Court of Appeals, the plaintiff apparently made an added argument (p. 458): that is, that "irrespective of any denial of actual knowledge, since the bank benefited by the diversion, it is subject to the requirements of the law to restore to the trust the funds which it received for its personal benefit." To this the court answered: "There is no evidence in the case whether or not the bank made any inquiry to determine if there were in existence any beneficiaries of the fund when the offset was made," and then went on as follows (p. 459): "The most that the statute does or was designed to do * * * is to create the possibility of a fiduciary relationship arising between the contractor * * * and a possible sub-contractor * * *. The statute does not give rise to a fiduciary relationship * * * or, if once created, continue it under any and all contingencies. Whether the moneys * * * are or may be the subject-matter of a trust depends exclusively upon the fact, * * * that the contractor

fails to pay the claims mentioned in the section. Nothing in the section bars the contractor from using the moneys received for any purpose he may see fit provided he does not fail to pay all such claims out of other moneys which he may then have or which he may afterwards receive, * * * There is no evidence in the case to indicate that the defendant knew or had any reasonable grounds to suspect prior to February 23, 1939, either that the plaintiff was a sub-contractor * * * or that it had any claim at any time * * *. Without such evidence there was no basis in the record for the judgment requiring defendant to return the moneys * * *." Finally (p. 462): "In clear terms those sections were not intended to create a real trust fund to remain such under any and all contingencies from the time the contractor or sub-contractor first received payment * * * ."

Thus the Court of Appeals did not think that the bank was put on notice as to whether there might be outstanding claims; it had no duty to inquire. The defendant's position in the case at bar is much stronger than the bank's in that action, for an inquiry would have shown that there were no existing claims whatever except that for which the plaintiff has recovered. If the plaintiff is to recover more, it can only be because it is a breach of trust for the contractor while the work is progressing to use any of the payments for his own purposes before the job is completed. That might have been the meaning but it was never expressed.

We have hitherto been discussing § 36(a) before its amendment in 1942, and we understand that the defendant argues that this changed the scope of the liability theretofore imposed. However, the section remained as before, word for word, except for the addition of two sentences: one, granting a "civil action" to enforce the trust regardless of a "subcontractor's" failure to file any lien; and the other providing that the trust funds shall include the right of action "upon an obligation for moneys due or to become due to a contractor." We can find no basis in those changes

for supposing that more was intended than to attach the civil sanction to the same liability to which the criminal sanction already attached. It would be an unwarranted construction of the change to suppose that, although the criminal liability remained subject to the former condition that the contractor "fails to pay the claims," the civil liability was relieved of that condition. Finally, we submit that the validity of a payment by a contractor to a third person must depend upon the situation as it exists when the payment is received: that is, the payee does not hold it subject to a condition subsequent that the contractor shall pay at their maturity upon future claims as they may arise as the work progresses. If invalid, it is invalid at once; any other construction would make the section a trap for those who dealt with the contractor. It is fair in this connection to remember that the Court of Appeals as part of its reasoning for holding that the unamended section imposed no civil sanction said (p. 463): "Though section 23 requires a liberal construction of the lien law it does not authorize judicial amendment so as to enlarge its clearly defined scope and purpose."

Judgment affirmed.

CLARK, *Chief Judge* (dissenting).

We have before us for construction important New York remedial legislation for the protection of laborers and materialmen on building jobs. The evil aimed at is that of "pyramiding," whereby a contractor parlays his speculations, using one undertaking as the basis of credit expansion for another, with lenders and security holders pretty well protected until, on ultimate disaster, those contributing labor or materials to a particular job are left holding an empty bag. And the remedy is the trust device first introduced in 1929 and now perfected by legislation of 1942, drafted, nurtured, and supported with complete documentation by that most distinguished embodiment of effec-

tive law reform, the Law Revision Commission of the State of New York. It is a matter of profound regret that my brethren have denigrated that source of precise and persuasive legislative history—so different from the usual confusion which such history tends to engender—which the Commission's records afford. Rather, taking some vague judicial remarks on earlier legislation, they have reacted against what is thought to be unduly harsh (more accurately, stern) measures against contractors and have fashioned a wholly original construction of the statute which substantially guts it in its immediate application here. And that, federal judges should not do to state law.

The conclusion herein reached is based on a construction of the crucial statute, N. Y. Lien Law § 36-a,[1] which denies to plaintiff, a supplier of materials on the particular improvement here involved, the intended benefit of the trust defined by the statute. But I am convinced that the plain-

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[1] This is that one of the several trust fund sections recommended by the Law revision Commission which is immediately pertinent here. It reads as follows:

> "§ 36-a. Contractor who diverts funds guilty of larceny; *civil remedy to enforce trust.* The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement, and to the payment of premiums on surety bond or bonds filed and premiums on insurance accruing during the making of the improvement and any contractor and any officer, director or agent of any contractor who applies or consents to the application of such funds for any other purpose and fails to pay the claims hereinbefore mentioned is guilty of larceny and punishable as provided in section thirteen hundred and two of the penal law. *Such trust may be enforced by civil action maintained as provided in article three-a of this chapter by any person entitled to share in the fund, whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement. For the purpose of a civil action only, the trust funds shall include the right of action upon an obligation for*

tiff is correct in claiming such benefit; and for demonstration thereof I shall rely on the Commission's scholarly "Act, Recommendation and Study relating to the Trust Fund Provisions of the Lien Law," 271-336 (1942). I note that the detailed supporting Study, 295-336, was prepared under the direction of that eminent scholar, Professor John W. MacDonald, who long served as Executive Secretary and Director of Research of the Commission and who has just now been honored by appointment to the Commission itself. Quite properly I should incorporate all this material with its voluminous annotations in this opinion, but it may be sufficient to give its flavor by briefer citation and quotation. The Commission summarized the existing law (1941) thus:

"Legislation has been enacted in New York and several other states to prevent abuses which frequently arise in the pyramiding of building operations and to afford adequate protection to those who contribute services or materials upon an improvement of real property.[2] Such legis-

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moneys due or to become due to a contractor, as well as moneys actually received by him." (The italicized words were added 1942.)

Art. 3-A, entitled "Enforcement of Trusts [New]," contains the seven sections now appearing as N. Y. Lien Law §§ 70-76. See "Note of Commission" referred to in note 12, *infra*.

[2] The following vivid description of the current abuses was quoted in the Study, 1942 Rep. N. Y. Law Revision Commission 298, 299, from Levitt's Guide to the Mechanic's Lien Law and Conditional Sales Law (written and published at the instance of The Association for the Revision of the New York State Lien Law, 1930) ¶ 279, pp. 149-150:

> "For years our larger centers of population harbored, and in fact, nurtured a type of builder and contractor who thrived on operations commenced by them but never completed by them. A builder of that type, after commencing an operation, adopted the practice of mortgaging such operation far beyond the value of his equity, before the contractor, materialman or subcontractor (intent only upon performing his contract, with no time or facilities for continuous searching or superhuman vigilance), realized his position. It must be noted that even

lation is based on the principle that funds received for an improvement should be applied to pay the cost of that

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care of an inconceivable nature, never prevented an overnight mortgage. Such builder would pocket the proceeds of these mortgages, while the men who contributed their material and labor, and made possible the very security for such mortgages, would be left holding the proverbial 'empty bag.' In fact, legitimate financial institutions unwittingly aided and abetted such unscrupulous builder by permitting him to divert even the building loan money. Time and again, such institutions learned to their sorrow, that the cost of completing an operation abandoned by such a builder, was greater than the amount named in the building loan mortgage.

"a—The honest builder, likewise, suffered by reason of the foregoing tactics, in that the honest builder found that he could not compete with one evading the payment of material and labor in the construction of a building. The honest builder, paying for an operation, could not, in selling the operation, compete with one who at times paid only about 25% of the cost.

"b—In the last analysis, even the dishonest builder, and may we say at this time, that a number of such builders may have been merely improvident, came to grief. The opportunity for diverting large sums of money with impunity, engendered a habit of pyramiding or mushrooming operations. By 'pyramiding' or 'mushrooming' we mean the use of mortgage monies from one operation for the purchase of additional land and the erection of buildings in other operations, thereby adding link upon link to this vicious chain. The concomitant result of such practice is now a matter of history. The deplorable condition in which the building trade now finds itself is directly traceable to that source—pyramiding—mushrooming. The dishonest or improvident builder found himself possessed of a host of buildings, but at the same time, tottering on the brink of ruin. The writer has interviewed many such builders, who, with tears in their eyes, confessed that if the law, now in force, had been on our statute books a year or two ago, they would now be men of substance, owning soundly financed buildings, which could be carried even during a falling market."

The author then stresses the penalizing of legitimate contractors unable to "meet the competition of these fly-by-nights, whose estimates did not include payment in full for material and labor," the burden on the renting public, the overproduction of buildings, and the express legislative intention that funds borrowed on the strength of an improvement should "reach its ultimate destination—material and labor—before such funds are taken by way of profits either by the owner, contractor or subcontractor."

improvement. It supplements the older remedy by lien upon the property improved, which is not available after all payments by the owner on his contract for the improvement have been made.[3]

"The first legislation was enacted in this state in 1929 at the time of the general revision of the Lien Law. It required that building loan mortgages contain a covenant by the owner to hold the moneys received thereunder as a trust to be applied first to the cost of improvement. Moneys so received were declared to constitute trust funds, a diversion of which was made punishable as a misdemeanor. Later the trust concept was extended to include moneys received by a contractor or subcontractor on account of an improvement, or upon an assignment of moneys due or to become due on a public improvement, as well as moneys received by an owner on a mortgage or conveyance, and proceeds of insurance on the improved property whether payable to an owner, contractor or subcontractor. Some of these statutes provide for the creation of a trust by covenant; others expressly declare the existence of a trust. Diversion of any such trust funds is now punishable as larceny." 1942 Rep. N. Y. Law Revision Commission 283.[4]

The Commission, to end widespread uncertainty concerning interpretation of the existing provisions, recommended legislation clearing up items of doubt. The critical part of the Commission's work for purposes of this case concerned the scope of the trust fund. Thus it approved the view urged unsuccessfully by the present plaintiff—that all

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[3] This is still true. See Friedman, *Protecting the Equitable Lien of the Subcontractor and Materialman*, N.Y.L.J., Oct. 30, 1956, p. 4, and Oct. 31, 1956, p. 4.

[4] For fuller description of the various legislative steps after 1929 in refining the trust fund concept, see Study, 1942 Rep. N. Y. Law Revision Commission 300.

money paid or owing to the contractor for work on one improvement constituted a single trust *res* for the benefit of all those who worked on that improvement. This idea of a single trust for a single improvement permeates every page of the official report. Nowhere in the study do the authors suggest the construction adopted by my brethren —that each installment payment constitutes a separate trust fund for the benefit of those who worked on the improvement prior to the payment of that installment. Nowhere in the comprehensive report is there discussion of the intricate problems of statutory construction and judicial enforcement raised by the novel gloss upon the statute here advanced.

So the explanation in the Study of the time when the trust arises is couched in terms which cannot be squared with our present opinion:

> "Closely allied to the problem of who are beneficiaries of the trust is the question as to when the trust arises. While it is elementary that there can be no trust without a beneficiary, the beneficiary may be designated by class rather than by naming specific individuals. Future members of the designated class may enjoy the benefits of a trust. It would seem that the trust arises as soon as the trustee designated in the provision receives the fund, and that such trustee is a resulting beneficiary, who is entitled to any remainder of the fund after it has been distributed to claimants entitled to share in it. The trust would continue until all claims for services and material on the improvement (by the classes designated in the statutory provision) have been paid. It would seem that even if no such claimant existed at the moment of receipt of the moneys by the contractor (or other trustee as designated in the trust fund provisions) a trust would

arise in favor of future claimants (*i.e.*, members of the classes for whose benefit the provisions were enacted). The contractor, subcontractor or owner, who is trustee, is in a position to know or to determine whether all claims are paid, and if they are not paid, he is also in a position to know it, even in absence of the requirement that claimants must file a lien to share in the trust fund, or in the case of non-lienable claimants, in absence of the claim being reduced to judgment. If, however, the filing of a notice of lien is requisite to establish a claimant as a beneficiary, it would seem no trust would arise, unless such notice were filed before the fund passed out of the possession of the contractor (or other trustee designated by statute). Moneys transferred by the contractor before the filing of a notice of lien would be taken free of a trust, the trust having failed for lack of any beneficiary, *i.e.*, lienor of the classes designated who filed notice of lien before the fund left the contractor's hands." 1942 Rep. N. Y. Law Revision Commission 325, 326.

The study group thus concluded that the interpretation urged by the plaintiff here was correct unless claimants were required to file notice of lien to qualify as beneficiaries. This idea had appeared in one Appellate Division case[5] and was followed by us in our first opinion in *Wickes Boiler Co.* v. *Godfrey-Keeler Co.*, 2 Cir., 116 F. 2d 842. The Commission took great pains to wipe out these two decisions which had cast doubt on what it considered the proper construction of the statute. It criticized them by name in the Report explaining the proposed amendments,[6] and it recom-

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[5] *New York Trap Rock Corp.* v. *National Bank of Far Rockaway*, 260 App. Div. 1035, 24 N.Y.S. 2d 426, affirmed 285 N. Y. 825, 35 N. E. 2d 498.

[6] 1942 Rep. N. Y. Law Revision Commission 283, 284.

mended that the various trust fund sections of the Lien Law be amended by the addition of the words: "Such trust may be enforced by civil action maintained as provided in article three-a of this chapter by any person entitled to share in the fund, whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement."[7] The Legislature passed the amendments as requested, thus ratifying the Commission's construction of the statute and rejecting the contrary interpretation of the first *Wickes Boiler Co.* case. It may be noted that we had already felt constrained to change our view there announced in our opinion on rehearing, *Wickes Boiler Co.* v. *Godfrey-Keeler Co.*, 2 Cir., 121 F. 2d 415, certiorari denied *Godfrey-Keeler Co.* v. *Wickes Boiler Co.*, 314 U. S. 686.

My brethren nevertheless adopt a construction of the amended statute which wars with its language, its legislative history, and New York case law,[8] and which clashes with other parts of the statutory scheme. In their view each installment payment by the owner to the contractor constitutes a separate trust *res* for the benefit of the men

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[7] 1942 Rep. N. Y. Law Revision Commission 287.

[8] Significantly, the two New York cases cited by the majority, *People* v. *Kew Gardens Terrace, Inc.*, 38 N.Y.S. 2d 246, and *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co.*, 288 N. Y. 452, 43 N. E. 2d 486, both involved the construction of the trust fund sections as they appeared before the 1942 amendments. In *Metropolitan Casualty Ins. Co. of New York* v. *Barr Wrecking Corp.*, 40 N.Y.S. 2d 607, Justice Froessel explained the difference between the statute before amendment construed in the *Raymond* case, *supra*, and the statute under its present wording. Subsequent New York cases have recognized that the 1942 amendments strengthened the trust fund provisions and overruled earlier decisions. E.g., *Ridgefield Supply Co.* v. *Rosen*, 1 Misc. 675, 147 N.Y.S. 2d 337; *Re Einach's Estate*, 1 Misc. 537, 146 N.Y.S. 2d 240; *Waldman* v. *D. & V. Plumbing & Heating Contractors*, 102 N.Y.S. 2d 787; *Wade* v. *Nassau Suffolk Lumber & Supply Corp.*, 275 App. Div. 864, 89 N.Y.S. 2d 294; *Application of Rafuse*, 82 N.Y.S. 2d 3, affirmed 83 N.Y.S. 2d 654; *Rosicato* v. *Manera*, 192 Misc. 607, 81 N.Y.S. 2d 353.

who worked on the improvement prior to the moment of payment. In the present case they decided that the owner's checks which the general contractor received after the plaintiff worked on the job may be traced into the defendant's hands, but that the checks received by the contractor for this same improvement before the date on which plaintiff started work are not held for plaintiff's benefit. The time at which a contractor receives an installment payment from the owner is now a critical fact in determining the rights of different claimants to the trust fund, although the trust fund may include money which is never paid by the owner to the contractor.[9] My brethren ignore the result of their construction: preferring laborers who do the first stages of construction, such as digging the foundation, over the men who do the last parts of a job, such as painting the interior. The former group of workmen can presumably look to all subsequent installment payments for security, while the last group has but one payment against which they can proceed.[10] The necessary effect of this decision

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[9] The last sentence of the amended § 36-a makes moneys owed but unpaid by an insurer or owner part of the trust *res*. See note 1 *supra*. Sec. 13(7) of the N. Y. Lien Law makes advances from the lender to whom the contractor assigned his contract part of the trust fund.

[10] The majority opinion does not make clear whether men who do the early stages of work have recourse only to the installment which immediately follows their work or whether they can look to all subsequent installments. If the former is the case, the one installment may be so burdened with creditors' claims that statutory cestuis get less than 100 cents on the dollar, while the next installment is so lightly taxed that nonbeneficiaries can enjoy diverted trust funds. An unscrupulous owner and contractor can time the payment of installments to help the lender at the expense of the cestuis.

If, on the other hand, the men who dig the foundation can look to all subsequent payments for security, they have a preference over painters, who could look only to the last installment. Making each payment a separate trust cannot fail to breed anomalies, since it makes cases turn on the happenstance of whether the owner's check arrived before or after a materialman performed.

is that ordinarily the early installment payments will never help the statutory beneficiaries, even though those beneficiaries do not have adequate satisfaction from later installments.[11]

The administrative complexity of my brothers' plan is enough to condemn it. To avoid criminal liability a contractor must not divert an installment check to a nonbeneficiary unless he is sure that all persons who performed during the time period covered by that check will be satisfied. To know whether a check may be paid to a nonbeneficiary the general contractor must now ascertain at his peril the percise claims of subcontractors, materialmen, laborers, insurers, and sureties which arose in the period covered by that installment check. I doubt if he will feel more free to use the check than he would had the plaintiff's construction of the statute been adopted.

So, too, the present decision means that in enforcement proceedings the plaintiff must prove the timing of each installment payment and the claims which are properly allocated to it—perhaps years after the event. Not only must he prove the *total* claims of each statutory beneficiary, but he must now also break down the claims and allocate them to the correct installment payments—an unnecessary addition to the length and complexity of the proceedings. It remains to be seen whether such expensive litigation will

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[11] This is most obvious where the owner pays an installment in advance and there are no materialmen who have worked prior to the payment of that installment. It is also true in the present case where the contractor borrowed money to pay the men who did the early stages of work on the improvement. These men were paid from borrowed money, and the first installment check was diverted to the lender. But from the next installment check the contractor was obliged to pay both the lender and the second group of materialmen which led to his default. Upon the default only the second group of materialmen needed recourse to the trust funds, the first group having already been paid. But under my brothers' rule, the first installment is for the exclusive enjoyment of the earlier group; and since they do not claim it, it may be diverted to nonbeneficiaries such as the lender.

be attempted by the persons whom the Legislature tried to help—workmen with small unsecured claims.

These amendments were the careful work of skilled draftsmen who had analyzed the prior statute and cases. They were adopted without change by the Legislature so that the Commission's consistent scheme was not marred. Introducing new wrinkles at this late date causes nothing but mischief.

The statute's natural reading is that all moneys paid or owing to the contractor for one improvement constitute a single trust fund for the benefit of men who worked on that improvement, and the manner and timing of the installment payments to the contractor are quite irrelevant. My brethren mention that here the owner had agreed to pay the contractor in installments as the job was completed. But not all contractors are paid in that fashion; it is hardly proper to construe the statute as leading to variable consequences as the owner and contractor alter their scheme of payments. These two parties are both strangers to the class of persons the statute is designed to protect, and nothing in the background suggests that their chance arrangements should control the scope of the trust fund.

My brethren cite *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co.*, 288 N. Y. 452, 43 N. E.. 2d 486, as requiring this result. Even if that case supported the defendant's view, it would not help us here, inasmuch as the case involved the original trust fund provisions before the critical 1942 amendments. Since the opinion of the Court of Appeals was filed after the Law Review Commission completed its work,[12] the Commission had no oppor

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[12] The case was decided July 2), 1942. The amendments were passed May 11, 1942. See *Metropolitan Casualty Ins. Co. of New York* v. *Barr Wrecking Corp.*, 40 N.Y.S. 2d 607, and the history of the amendments in the Assembly given in 1942 Rep. N. Y. Law Revision Commission 773, also *id.* 789, 790, setting forth the note defining the origin and purpose of the legislation which now appears as "Note of Commission" preceding N. Y. Lien Law § 70.

tunity to say how much of that opinion remained good law after passage of the amendments. The Commission did approve the Appellate Division result,[13] however, which the Court of Appeals reversed. The first ground of the final opinion—that the trust fund sections are only criminal and not civil—was clearly overruled by the amendments. The second ground—that funds cannot be traced into the hands of third persons who received them without notice of their trust character—was approved by the Commission[14] and is still good law. But it does not bar recovery by the plaintiff in this case where the trial court carefully documented its finding that the defendant had notice that the moneys he received were diverted trust funds.[15]

The full remarks of the Court of Appeals show that it never approved the result we reach today. Its opinion was carefully sprinkled with such words as "on the pleadings and the proof as presented," "There is no evidence in the case to indicate that * * *," "Without such evidence, there was no basis in the record for the judgment * * *," "In the circumstances disclosed by the record * * *"—which show that the result turned on insufficient proof of notice, and not on this novel construction of the statute.

The judicial hostility to the trust fund provisions, which we are evincing, but which have been conspicuously absent in the state decisions under the amended statute,[16] seemingly stems from fear that the trust fund concept will prove too restrictive. Where third persons are being sued to recover diverted funds, the potential hardship of the statute is controlled by the requirement that the defendant have

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[13] 1942 Rep. N. Y. Law Revision Commission 316.

[14] 1942 Rep. N. Y. Law Revision Commission 315-317.

[15] Palmieri, *J.*, at 143 F. Supp. 641, 646, 647.

[16] Cases cited *supra* note 8.

received the funds with notice of their trust character.[17] As to contractors' liability, the stern effect may be greatly exaggerated. My brethren suggest that the plaintiff's reading of the statute would require contractors to husband all payments until the end of the job. But the Commission noted that the contractor may use the fund with impunity to pay any person who falls in one of the statutory classes.[18] And the funds may be safely diverted to nonbeneficiaries, as the Court of Appeals observed,[19] just as long as the contractor eventually paid the statutory classes out of other moneys. The contractor will face the danger of criminal liability only if he diverts trust funds without knowing how he is going to pay his materialmen and subcontractors. In other words the statute prevents "pyramiding."

The record in the present appeal suggests that pyramiding still occurs in New York, and that persons like the plaintiff still need protection. The earlier state cases, down through the *Raymond* decision, did evince sufficient hostility to require the careful corrective provisions developed so ably by the Law Revision Commission. I suggest that it is to say the least anomalous for us now to take up the cudgels for the pyramider and raise obstacles to the enlightened Commission and legislative program which have never occurred to the state courts.

I think we should reverse and remand for further proceedings, as herein indicated.

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[17] 1942 Rep. N. Y. Law Revision Commission 315.

[18] 1942 Rep. N. Y. Law Revision Commission 328, 329.

[19] *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co.*, 288 N. Y. 452, 459, 43 N. E. 2d 486.

Appendix

JUDGMENT

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 7th day of January one thousand nine hundred and fifty-seven.

Present: HON. CHARLES E. CLARK, Chief Judge,
HON. LEARNED HAND,
HON. THOMAS W. SWAN,
Circuit Judges.

GRAMATAN-SULLIVAN, INC.,
Plaintiff-Appellant,

v.

NATHAN KOSLOW, Individually and as principal of an unincorporated entity or assumed name d/b/a "C.N.K. Co.",
Defendant-Appellee.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed.

A. DANIEL FUSARO,
Clerk.

DARK PAGE BLEED THRU

No. 877

FILED
APR 3 19
JOHN T. FEY, C

United States Court of Appeals

FOR THE SECOND CIRCUIT

GRAMATAN-SULLIVAN, INC.,

Plaintiff-Appellant,

against

NATHAN KOSLOW, individually and as principal of an unincorporated entity or assumed name doing business as "C. N. K. Co.",

Defendant-Appellee.

(Civil Action No. 99—300)

APPELLANT'S BRIEF AND APPENDIX

On Appeal from the United States District Court for the Southern District of New York

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Prime Brothers & Duffy,
Attorneys for Plaintiff-Appellant,
45 South Broadway,
Yonkers 2, New York.

FILED
JUN 11 1956
UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

INDEX TO BRIEF

PAGE

Statement of Case 1

The Issue Here 3

Argument 5

Errors Claimed as to Facts 5

POINT I—The only fair construction to be given to Sec. 36-a, Mechanics Lien Law is that the trust attribute continues so long as the fund remains unexpended and any job creditors unpaid 12

POINT II—This court should construe the Act; sustain the appeal as taken and remit the matter to the District Court to proceed in conformity therewith 15

Conclusion 15

Chronological Addendum 16

CASES CITED

Donischefsky v. Klein Watson Co., 244 N. W. 722 .. 8-11

Fogarty v. City of Albany, 157 Misc. 30 14

Hayden v. Pierce, 144 N. Y. 512-516 14

New York Trap Rock Corporation v. National Bank of Far Rockaway, 285 N. Y. 825 12

Piersen v. People, 79 N. Y. 424-434 14

Raymond Concrete Pile Co. v. Federation Bank & Trust Co., 288 N. Y. 52 7-9-10

Riggs v. Palmer, 115 N. Y. 506-509 14

PA

Smith v. People, 47 N. Y. 333-340 .....

Standard Sand & Gravel Co. v. City of New York, 224 N. Y. 687 .....

STATUTES CITED

New York Mechanics Lien Law,
§ 23 .....
§ 25a 8-9-10-12-
§ 36a 1-2-4-7-8-9-
§ 71 1-2

New York Penal Law, § 1302 .....

New York Civil Practice Act, § 195 .....

AUTHORITY

Report (N. Y.) Law Revision Commission (1942) ...13-

INDEX TO APPENDIX

Statement Under Rule 15(b) 1

The District Judge's Opinion 3

DARK PAGE B

United States Court of Appeals

FOR THE SECOND CIRCUIT

GRAMATAN-SULLIVAN, INC.,

Plaintiff-appellant,

against

NATHAN KOSLOW, individually and as principal of an unincorporated entity or assumed name doing business as "C. N. K. Co.",

Defendant-appellee.

APPELLANT'S BRIEF

Civil 99-300

Statement of the Case

This is an appeal by the plaintiff from so much of a judgment in its favor as determines as a matter of law that:

"(1) appellant's right to pursue diverted lien funds under § 36-a and 71 of the Lien Law of the State of New York is limited to $321.60 and determines as a matter of law

(2) That under the provisions of § 36-a of the Lien Law of the State of New York a statutory trust arises only to the extent that there are unpaid outstanding claims at the time of the diversion and only to the extent of said claims

ED THRU

(3) That the provisions of § 36-a of the Lien Law of the State of New York do not purport to create a real trust fund to remain such under any and all contingencies until all job creditors have been paid.

The action was brought under the provisions of the Lien Law of the State of New York (Sec. 36-a) to have the respondent declared a constructive trustee (trustee ex maleficio) of $11,900.00 of a contractor's building fund, which because of this diversion became insufficient to meet the maturing claims of Shaw's job creditors.

Plaintiff's complaint, wherein it sued not only on its own behalf but on behalf of all others who might elect to come in and join in the prosecution of the action, alleged that it was a job creditor of A. Shaw & Co., Inc. (hereinafter called "Shaw") to the extent of $33,429.81 on the job Shaw as general masonry contractor was progressing for Villa Manor Realty Corp. (hereinafter called "Villa Manor").

The respondent's answer was a general denial of all the allegations of the complaint, excepting paragraphs II and IV; but in response to a "demand to admit" (under Rule 36 record pp. 167-170) conceded the truth of almost all of paragraphs V, XI, XIII, XIV and XV of the complaint.

The District Judge sustained plaintiff's complaint and while it found there was a diversion of $11,900.00 by the contractor in its passing job funds to that extent to the respondent, who was not a job creditor, he awarded appellant relief only to the extent of $321.60 because up to and during the diversion period appellant had only delivered merchandise of that value (p. 5a).

The precise language of the Judge is to be found in his opinion, page 6a, where we consolidate in one quotation

his question and his conclusion:

> "Thus, the main question in the case is whether §36-a creates a trust for the benefit of all potential job claimants or whether, on the contrary, the trust arises only to the extent of unsatisfied, outstanding claims. For reasons stated more fully hereafter, it is held that the statutory trust arises only in the event that there are unpaid claims outstanding and only to the extent of such claims." (p. 6a)
>
> "The plaintiff may recover nothing in excess of the $321.60 representing the goods delivered prior to Shaw's second payment to Koslow. As to that sum, the evidence established that Shaw's payment to Koslow was a diversion of trust funds concerning which the defendant Koslow had constructive notice." (p. 6a)

The Issue Here

The issue here is raised by the Court's failure to consider the provisions of Secs. 36a and 71 of the Lien Law so as to protect all job creditors as listed in § 36-a, rather than limiting the relief to those who were creditors at the moment of diversion.

The District Judge stated the problem in these words (middle p. 6a):

> "The scope of the limitation imposed by Section 36-a on a contractor's freedom to dispose of funds to or received from an owner has not been precisely delineated by the New York Courts." (p. 6a)

The District Judge on pages two and three of his decision (p. 4a) sets forth what purports to be a quotation of Sections 36-a and 71 of the Lien Law, but because of omission from the text of the respective Sections

(indicated in his decision by (———) the quoted language does not adequately cover the Act and for that reason we set out both sections in *haec verba* as follows:

"§ 36-a. Contractor who diverts funds guilty of larceny; civil remedy to enforce trust

The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement, and to the payment of premiums on surety bond or bonds filed and premiums on insurance accruing during the making of the improvement and any contractor and any officer, director or agent of any contractor who applies or consents to the application of such funds for any other purpose and fails to pay the claims hereinbefore mentioned is guilty of larceny and punishable as provided in section thirteen hundred and two of the penal law. Such trust may be enforced by civil action maintained as provided in article three-a of this chapter by any person entitled to share in the fund, whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement. For the purpose of a civil action only, the trust funds shall include the right of action upon an obligation for moneys due or to become due to a contractor, as well as moneys actually received by him. As amended L. 1942, c. 808, § 4 eff. Sept. 1, 1942."

"§ 71. Enforcement of trusts arising out of contract for public or private improvement; procedure A trust described in sections four-a, thirteen, subdivisions three, five, six and seven, twenty-five, sub-

divisions five and six, twenty-five-a, twenty-five-b, thirty-six, thirty-six-a or thirty-six-b of article two of this chapter may be enforced by any person entitled to share in the trust fund in a representative action brought for the benefit of all persons entitled to share in the fund.

In any such action, except as otherwise provided in this article, the practice, pleadings, forms and procedure shall conform as nearly as may be to the practice, pleadings, forms and procedure existing at the time in actions brought under section one hundred ninety-five of the civil practice act. Added L. 1942, c. 808, § 15, eff. Sept. 1, 1942."

ARGUMENT

Errors claimed as to facts.

The only testimony which appellant considers it necessary to print has to do with erroneous statements by the District Judge as to the facts, and before quoting the testimony we set forth the statements of the Judge which we consider unsupported by the testimony. For instance, he declared at the upper part of page 5a:

"As of May 28th, however, the date of Shaw's first payment to Koslow there were no job claims outstanding against the contractor."

Immediately following that quotation he proceeded further (middle of page 5a) to say:

"Gramatan & Sullivan had neither made nor contracted for any deliveries to Shaw".

Further, on lower half of page 5a, he said:

"from the facts shown it is apparent that the plaintiff seeks, as to the first check, to impress a trust on

funds received and paid out by Shaw at a time when there were no job claims outstanding against the contractor."

These quoted utterances are unsupported by the record, in fact they are contradicted by the testimony, because at page (tdps. 100), Shaw testified in answer to a long question by the Court:

"A. The job was away overboard". (tdps. 100)

"Q. When did you start work on the Villa Manor job? What was your first day? A. I wouldn't want to be pin-pointed on the first day. Let me say the last—probably the last week in April or the first week in May". (tdps. 113)

"Q. You knew, did you not, that there was an outstanding indebtedness on the part of A. Shaw & Co., Inc. to the plaintiff in this case, Gramatan & Sullivan, Inc. for unpaid building materials? A. Yes, he supplied during May; yes supplied all during May and June." (tpds. 149)

"Q. Will you explain what that means? A. 'We figured a low figure and it went away above what it should have been.'" (tdps. 100)

"Q. Did you ever discuss with Mr. Paterno as to the cost of the job, as to what your predicament was? A. 'I did not discuss it, in view of the money owed to various creditors you mean.'" (tdps 101)

"The Court:

"Q. So, I take it you were unable to meet your current obligations there without borrowing? A. That is right." (tdps. 108)

"Q. Of course, in order to do the operation of that job in the month of May you had to expend, that is, your corporation had to expend moneys for labor, for material, is that correct? A. That is right." (tdps. 133)

From a reading of this segment of the testimony it must be clear that the record does not support the above quoted statements by the District Judge and it must be a matter of judicial knowledge that with a job starting in May and with the first payment by the owner to the contractor due (Exhibit 1) between the 15th and 25th days of June to the extent of 80% (later changed to 95%) that there must have been moneys owing to job creditors even if only limited to workmen and compensation insurance carriers.

We submit that the District Judge was in error when, with an $8,900 check in hand, all of which was received and kept by the respondent Koslow, it was error to say that the proceeds were divisible into two segments, the taking of one being larcenous and the other segment of which was legal.

An analysis of Section 36-a will clearly demonstrate that those moneys, both the monthly payments and the retained percentages constituted a reservoir to be maintained, so far as the moneys permitted, until the last job creditor had been paid and not strain statutory interpretation to the point where they became trust funds only if, while quickly passing through the conduit of the contractor's bank, a given supplier happened to be an unpaid creditor. This construction is contradicted by the latter portion of Section 36-a where the rights of a civil action are conferred upon any person entitled to share in the fund, "whether or not he shall have filed, or had a right to file, a notice of lien * * *", and further in conclusion it pertains to "moneys due or to become due thereunder."

Repeating what was said by the District Judge about the issue before him as being a case of first impression (our words, not his) his first reference to decided cases was the New York Court of Appeals decision in *Raymond Concrete Pile Co.* v. *Fed. Bank & Trust* reported in 288 N. Y. 452, followed by references to the Second Depart-

ment, Appellate Division decision in 1937 of the case of *Vulcan Rail Construction Co.* v. *Westchester County*, 250 A. D. 212, which he said clearly imported (bottom page 7a decision) "* * * that no trust arises under Section 36a of the Lien Law in the absence of unpaid claims outstanding against the contractor" (page 7a). To sustain this statement he has recourse to a Wisconsin statute construed in the case of *Donischefsky* v. *Klein-Watson Co.* in the Superior Court of Wisconsin, 210 Wis. 210, 244 N. W. 722 (1932), which three citations we shall proceed to distinguish and differentiate, not only in their relationship to the case at bar, but as based on entirely different statements of fact and not as emasculating the intent of the Legislature in enacting § 36a of Mechanic's Lien Law.

The first named case (which we shall refer to by the word "Raymond" for brevity of utterance) had to do with an action by a non-lien creditor against a bank in which the general contractor one O'Connor, Inc. maintained an account and in which it deposited the proceeds of a check received by it from the City of New York for work on the then new Criminal Courts Building and who made on February 17, 1939, a deposit of $178,000.00 (a Friday),which check on that day cleared through the Clearing House. On Monday morning, February 20th, the bank offset against the credit of the depositor's account a note given by O'Connor, Inc., on the preceding Friday, the 17th, when its account was overdrawn. At the time of such offset by the bank and debit to the depositor's account of $78,000.00 the Lien Law relating to public improvements (Section 25a of the Lien Law) as it had been enacted in the year 1932 did not contain a clause (which it now does) reading as follows: (vide 25a as amended chapter 808 Section 2 Laws 1942)

> "such trust may be enforced by civil action maintained as provided in Article 3a of this chapter by any per-

son entitled to share in the fund *whether or not he shall have filed or had the right to file* a notice of lien or shall have recovered a judgment for a claim arising out of the improvement. For the purpose of a civil action only the trust funds shall include the right of action upon an application for moneys due or to become due to a creditor as well as moneys actually received by him". (emphasis supplied.)

At that time (1939) Section 36a also lacked two concluding sentences similar to the last foregoing quotation and the opinion of Rippey, J., concurred in by Judge Lehman and all of the associate judges, reversed the determination of the Appellate Division, First Department (261 A. D. 25) and sustained the dismissal of the complaint on the merits (174 Misc. 206), upon the ground that by Section 25a of the Lien Law, the Legislature did not contemplate the creation of

> "a trust relationship which would give rise to a cause of action in behalf of the subcontractor which he would not otherwise have under the common law or under any other provision of the Lien Law or under any other statutory provision." (pp. 458-459)

The Court prefaced its utterance of the last quoted matter by saying:

> "From the facts in this case no trust or fiduciary relationship between the contractor and his subcontractor arose or existed under the common law." (p. 458)

It must therefore appear that the decision in the *Raymond* case was made and was sustainable because it was decided at a time when in July 1942 it passed upon the law as it then was and without regard to the amendment which had been made by the Legislature in the Spring

of 1942 (May 11, 1942) to be "effective September 1, 1942". We submit that from there on discussions in the opinion having to do with notice to the bank and whether "it had any reasonable ground to suspect prior to February 23, 1939 * * *" either that Raymond "was a subcontractor in connection with such improvement work or that it had any claim at any time * * * or that any other person referred to in Section 25a of the Lien Law have any such claim was pure obiter. So also is the discussion, page 459 of presumptions upon which the bank was entitled to rely, that the moneys were not trust funds and without any beneficiary. Likewise, at page 460 where the Court discusses the origin and the legislative history and the wording and the character of Section 25-a, it is dealing with a statute as it then existed, which was much more limited in its application than are the Sections quoted by the Judge, as 36a and 36b which specifically characterize such moneys as trust funds. Even the District Judge admits that the crux of the situation in the *Raymond* case was that "the trust created by the Statute could not be civilly enforced" (p. 8a).

The second case discussed by the District Judge was the *Vulcan Rail* case (250 A. D. 212), decided five years before the enactment of the amendment to Sections 25a and 36a granting the right to claimants to maintain a civil action for the enforcement of their rights and in the second cause of action decreed the invalidity of an assignment lacking a trust clause.

The District Judge's concluding remarks relative thereto was

> "The Court denied recovery on the ground that the Bank had no knowledge, at the time of the deposit, that there were any job claims outstanding against the contractor" (p. 7a).

A reading of the Appellate Division decision will show that the judgment of the Court below was affirmed as

against the plaintiff-appellant-respondent and as against the respondent-appellant, Tarrytown National Bank & Trust Co., County Sand & Stone Corp., New York Trap Rock Corp. and Travelers Indemnity Co., wherein the second cause of action in the complaint had been dismissed, also certain counterclaims, the Court holding that the section of the Lien Law (36a) upon which the plaintiff and certain defendants relied had no application since it refers only to owners of "real property" and not to a public improvement as discussed in Section 25a of the Lien Law which was not in effect when the payments involved were made. Furthermore, the denial of validity in an assignment lacking the trust clause was held to be mandatory and the assignment of the defendant bank was for lack of such clause invalidated. That hardly sustains the quoted section of the District Judge's comment, and makes it entirely inapplicable to the facts here existing.

The *Danischefsky* v. *Klein Watson* case (Wisconsin) did not involve any question of who should be the proper distributees of moneys in custody; nor did it involve the foreclosure of a mechanics lien.

The only question there involved was whether or no County orders held by the Contractor were "property" of a defendant sufficient to sustain a writ of attachment. Danischefsky was a creditor of the defendant Klein Watson, a corporation foreign to the State of Wisconsin. On February 13, 1932, three county orders aggregating $5750.00 were executed by the County of Milwaukee and delivered to the office manager of Klein Watson. On that day the Sheriff of Milwaukee County attached them; at which time there were no notices of lien on file. The lower court dissolved the attachment on the ground that the proceeds were trust funds; and on that ground and on the further ground that county orders are not subject to attachment, vacated the attachment.

The Appellate Court in reversing the Circuit Court held, in effect, that only creditors can raise the issue of job

moneys being trust funds; that the debtor may not raise the question saying (244 N. W. 722):

> "It was not intended to be a shield to enable a contractor to defeat claims of other creditors where there are no outstanding obligations of the kind described in the statute (liens) due to workmen or material men."

While the District Judge does not cite the case of *New York Trap Rock Co.* v. *Bank of Far Rockaway,* 285 N. Y. 825, it is discussed in the Raymond case where a reading of the *per curiam* opinion of the New York Court of Appeals will show the existence of an undecided proposition of law, the Court saying:

> "We agree that regardless of the construction of the scope and the effect of section 25-a of the Lien Law, no action at law can be brought by a single creditor. The determination of the construction and effect of section 25-a must await a case in which such question is necessarily presented." (p. 826)

POINT I

We urge that the only fair construction to be given to § 36-a mechanic's lien is that the trust attribute continues so long as the fund remains unexpended and any job creditors are unpaid.

To hold otherwise would be to attribute to the Legislature an utter inability to express clearly what they intended to accomplish. Had they intended only to protect suppliers who were creditors at or before the moment of diversion they could have phrased § 36a (ML) to read:

> "The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such

contractor to be applied first to the claims *'then due and owing'* of subcontractors * * * etc. (Italics supplied)

Such trusts may be enforced by civil action maintained as specified in Article 3-a of this chapter by any person entitled to share in the fund *'who was a creditor at the time of the diversion'* whether or not he should have filed a lien or had the right to file a lien." (Italics supplied)

Furthermore, we are supported in this contention by the recitals and in the Report of the Law Revision Commission (1942) on which the District Judge seemingly relied (p. 10a) in which connection we desire to point up the intention of the Committee from the same work as gathered by a reading of subsequent paragraphs to which his Honor did not allude and perhaps did not read.

If we refer to page 55 (also numbered 325) thereof, where under the heading "when does trust arise" we find recorded the following:

"Future members of the designated class may enjoy the benefits of a trust. It would seem that the trust arises as soon as the trustee designated in the provision received the fund, and that such trustee is a resulting beneficiary, who is entitled to any remainder of the fund after it has been distributed to claimants entitled to share in it. The trust would continue until all claims for services and material on the improvement (by the classes designated in the statutory provision) have been paid. It would seem that even if no such claimant existed at the moment of receipt of the moneys by the contractor (or other trustee as designated in the trust fund provisions) a trust would arise in favor of future claimants (i. e. members of the classes for whose benefit the provisions were enacted)."

and at (p. 57 also numbered 327):

> "In the cases discussed hereinabove in which a transferee for value had possession of the trust moneys, the trust was held to continue and was enforcible where the transferee had notice, either actual or constructive, of the trust character of the fund. In one of these cases the court observed:
>
> > Until the job was completed and the time for filing liens had expired, the bank was bound to know that the trust continued."[13]
>
> It must be noted that the claimants in this case were lienors, and that the court apparently proceeded on the theory that filing of notice of lien was necessary to secure the benefits of the trust. This case indicates that the trust arises when the moneys are received by the trustee or one claiming under him, and is for the benefit of future claimants, that is all those who may file liens within the legal period."

We close with a quotation from the *Amiesite* decision, *supra*.

"By its terms, found in section 23 thereof, the Lien Law (Consol. Laws. Chap. 33) is to be construed liberally to secure the beneficial interests and purposes thereof. The law has as its general scheme and underlying purpose the securing of compensation to those who contribute labor or materials to the improvement of real property (p. 827). * * *

Under settled canons of construction (*Standard Sand & Gravel Co.* v. *City of New York*, 172 App. Div. 80, 82; affd. 224 N. Y. 687; *Riggs* v. *Palmer*, 115 *id.* 506, 509; *Hayden* v. *Pierce*, 144 *id.* 512, 516; *Pierson* v. *People*, 79 *id.* 424, 434), the statute, construed liberally, must and does mean

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[13] (Fogarty v. City of Albany), 157 Misc. 30.

that such funds become trust funds when they are appropriated to the contract by the State and are due and owing to the contractor, although not actually received by him (p. 827). * * *

If the remedial purpose of section 25-a may be circumvented by the expedient of such an assignment, the section is practically a nullity, "and the Legislature did a vain thing which the law will not intend" (*Smith* v. *People*, 47 N. Y. 330, 340)." (p. 827).

For all of the foregoing reasons the trust clause should be construed in the light of the legislative intent. If the District Judge's interpretation is to stand, any contract money may be diverted by doing it early enough to escape the first debit charge of a job creditor, whereupon the trust provisions (p. 4 hereof) are completely emasculated, and the intention of the Legislature (pp. hereof) is frustrated or defeated.

POINT II

This Court should construe the act; sustain the appeal as taken and remit the matter to the District Court to proceed in conformity therewith.

All of which is respectfully submitted.

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ADDENDUM

(To aid the Court in visualizing the growth and development of the law relative to the trust clause, and its bearing on decisions discussed herein.)

Chronological

Effective date (or date decided)	
May 2, 1916	Bischoff v. Yorkville Bank, 218 N. Y. 106.
Oct. 1, 1929	Chap. 515 N. Y. Laws amends § 2 Mechanic's Lien Law.
Oct. 1, 1930	Chap. 859 N. Y. Laws amends § 17 Mechanic's Lien Law (these two are first of series of amendments of Lien Law which had stood almost unchanged since 1909, Law of 1932, Chap. 627).
June 1, 1932	Clarke v. Public National Bank & Trust Co. of N. Y., 259 N. Y. 285.
July 1, 1932	§ 25a N. Y. Mechanic's Lien Law, amended (enacts trust clause silent on civil remedy).
July 1, 1932	§ 36 N. Y. Mechanic's Lien Law, amended (owner diversion—silent on civil remedy).
Oct. 10, 1932	Danischefsky v. Klein-Watson Co., 210 Wisc. 210, s. c. 244 N. W. 722.
Mar. 1935	Fogarty v. City of Albany, 157 Misc. 30.
May 22, 1935	Barclay v. Corn Exchange Bank, 155 Misc. 684.
Feb. 2, 1937	Bray Bros. Inc. v. Marine Tr. Co. of Buffalo, et al., 35 Supp. 2d 356.

Effective date (or date decided)	
Mar. 5, 1937	Vulcan Rail v. County of Westchester, 250 A. D. 212.
Mar. 27, 1937	Century Indemnity Co. v. Bank of Gowanda, 35 Supp. 2nd 396.
Nov. 23, 1937	Bonham v. Coe, 276 N. Y. 540.
Apr. 8, 1940	Amiesite Construction Corp. v. Luciano Contracting Co., °259 A. D. 826.
Nov. 19, 1940	Amiesite Construction Corp. v. Luciano Contracting Co., 284 N. Y. 223.
Dec. 16, 1940	N. Y. Trap Rock Co. v. Natl. Bank of Far Rockaway, °260 A. D. 1035.
Dec. 20, 1940	Raymond Concrete Pile Co. v. Federation Bank & Trust Co., **261 A. D. 25.
Dec. 24, 1940	Wickes Boiler Co. v. Godfrey-Keeler Co. (Second Circuit), *116 Fed. 2 842.
Apr. 15, 1941	Century Indemnity Co. v. Bank of Gowanda, °35 Sup. 2nd 396.
May 2, 1941	N. Y. Trap Rock Co. v. National Bank of Far Rockaway, 285 N. Y. 825.
June 21, 1941	Wickes Boiler Co. v. Godfrey-Keeler Co. (Second Circuit), 121 Fed. 2 415.
Oct. 9, 1941	Stancs v. County Trust Co. (enforces trust for lienors, but not for non-lienor), 262 A. D. 1039.

° Subsequently affirmed.
** Reversed in 288 N. Y. 452.
* Reversed in 121 Fed. 2d 415.

Effective date (or date decided)	
Mar. 27, 1942	Century Indemnity Co. v. Bank of Gowanda, 263 A. D. 1068.
May 11, 1942	Law passed and signed amending §§ 25a, 36a and 71—Mechanic's Lien Law—Ch. 408 Law 1942.
July 20, 1942	Raymond Concrete Pile Co. v. Federation Bank & Trust Co., 288 N. Y. 452.
Sept. 1, 1942	°°§ 25a effective (adds remedy of civil enforcement with or without lien), Laws 1942 Chap. 808.
Sept. 1, 1942	°°§ 36 effective (adds remedy of civil enforcement with or without lien) Laws 1942 Chap. 808.
Sept. 1, 1942	°°§ 36a effective (adds remedy of civil enforcement with or without lien) Laws 1942 Chap. 808.
Nov. 6, 1942	Century Ind. Co. v. Bank of Gowanda, 265 A. D. 907.

°° Enacted May 11, 1942.

APPENDIX

UNITED STATES COURT OF APPEALS,

FOR THE SECOND CIRCUIT.

Civil 99-300.

GRAMATAN-SULLIVAN, INC.,

Plaintiff-Appellant,

against

NATHAN KOSLOW, individually and as principal of an unincorporated entity or assumed name doing business as "C. N. K. Co.,"

Defendant-Appellee.

Statement Under Rule 15 (b)

Suit was commenced on March 30, 1955, by the service of process on Nathan Koslow, the respondent. The Complaint was filed in the District Court on March 28, 1955.

Originally A. Shaw & Co. Inc., Mildred Shaw and Arthur Shaw were included in the summons and complaint as defendants; but Mildred Shaw and Arthur Shaw remaining outside the jurisdiction of the court were never served; A. Shaw & Co. Inc., was served in the Southern District on the 29th day of March, 1955, and defaulted in answering. On the trial the action was discontinued as to A. Shaw & Co. Inc., Mildred Shaw and Arthur Shaw by motion made and granted by the Court on motion of plaintiff's counsel.

Plaintiff prepared and served and filed a demand to admit under Rule 36 on the 26th day of April, 1955, directed to Nathan Koslow and his response thereto was filed with the Clerk of the District Court verified the 5th day of May, 1955.

Statement Under Rule 15 (b).

The defendant Nathan Koslow was examined before trial in the Southern District on the 7th day of July, 1955, and his filed and sworn deposition was filed with the Clerk of the District Court on the 1st day of September, 1955.

The trial was had without a jury before Hon. Edmund L. Palmieri, District Judge, on the 2nd and 3rd days of February, 1956. Proposed findings of fact and conclusions of law were submitted to the District Judge before decision, with both sides filing exceptions thereto. The District Judge never passed upon the findings and never transmitted them in any form to the District Court Clerk's Office.

Judgment was entered on the 3rd day of April, 1956, by the Clerk on the opinion of Palmieri, D. J., dated the 29th day of March, 1956, in favor of the plaintiff for $321.60.

No appeal was taken by the defendant Koslow. Plaintiff's Notice of appeal was filed with the Clerk of the District Court on the 2nd day of May, 1956, and by him served in usual course upon the attorney for the respondent.

JUDGMENT (There is no judgment, the monetary award having by virtue of the direction of the Court been docketed as a money judgment for $321.60 on April 3, 1956, without any affirmative action on the part of the appellant.)

DECREE (There is no decree in this case).

ORDER APPEALED FROM. (There is no separate order—see opinion).

OPINION. (see p. 3a)

FINDINGS OF FACT AND CONCLUSIONS OF LAW (not passed on—see preamble hereto).

CHARGE OF THE COURT (Being tried without a jury there is no charge).

Further compliance with Rule 15, Subdivision B, is considered unnecessary because the questions on review involve only a determination of issues of law and a construction of the New York State Mechanic's Lien Law, Section 36a and Section 71, and which construction requires only the opinion of the Court below.

Opinion by Palmieri, D. J.

(Record pages 176 to 193)

APPEARANCES:

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Francis J. Duffy, Esq., of Counsel.

BENJAMIN JAFFE, Esq., Attorney for Defendant, 11 West 42nd Street, New York, New York.

PALMIERI, D.J.

The plaintiff, a supplier of building materials, seeks to recover part of a debt of $33,421.89 concededly owed to it by a building contractor, A Shaw & Co., Inc. (Shaw). It brings this action to impress a trust on funds paid to the defendant Koslow by Shaw in liquidation of a money debt. The action is brought under §§ 36-a and 71 of the New York Lien Law. Jurisdiction is founded upon diversity of citizenship.[1]

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[1] The plaintiff is a corporation incorporated under the laws of the State of New York. Koslow is a resident of New Jersey. The complaint as originally framed named both Koslow and Shaw as defendants. Shaw, however, is a New York corporation. To cure the resultant lack of diversity jurisdiction, the plaintiff moved at the outset of the trial to amend the complaint, discontinuing the action against A. Shaw & Co., Inc. and striking allegations that the latter was an indispensable party. [For reasons stated at the conclusion of this opinion, these motions are deemed to be granted.]

Sections 36-a and 71 of the Lien Law provide as follows:

> "The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement, . . . and any contractor and any officer, director or agent of any contractor who applies or consents to the application of such funds for any other purpose and fails to pay the claims hereinbefore mentioned is guilty of larceny. . . . Such trust may be enforced by civil action maintained as provided in article three-a of this chapter by any person entitled to share in the fund, whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement. For the purpose of a civil action only, the trust funds shall include the right of action upon an obligation for moneys due or to become due to a contractor, as well as moneys actually received by him. Lien Law §36-a (as amended L. 1942, c. 808, §4, eff. Sept. 1, 1942.)
>
> "A trust described in section . . . thirty-six-a . . . of article two of this chapter may be enforced by any person entitled to share in the trust fund in a representative action brought for the benefit of all persons entitled to share in the fund." Lien Law §71 (added, L. 1942, c. 808, §15, eff. Sept. 1, 1942).

It was established at the trial that Villa-Manor Realty Co., Inc., (Villa Manor) owner of the realty improvement, paid two installments on its contract with Shaw at the end of May and the beginning of June, 1954. Both payments were by check. The first, dated May 28th, was for $3,000.

The second, dated June 4th, was for $8,900. Both checks were endorsed over by Shaw, the contractor, directly to defendant Koslow on the dates drawn. Koslow deposited them in his bank account on the same dates.

The total of the two checks, $11,900, is the amount sued for in this action. Plaintiff contends that at the time of the indorsement over, the checks were held by Shaw in trust for its benefit.[2] Thus it maintains that Koslow is liable for the return of trust funds improperly diverted.

As of May 28th, however, the date of Shaw's first payment to Koslow, there were no job claims outstanding against the contractor. Gramatan-Sullivan had neither made nor contracted for any deliveries to Shaw. On June 1st, 2nd and 3rd, the plaintiff delivered sand and mortar to Shaw at a total price of $321.60. This was the only job debt proved to have been incurred by Shaw prior to June 4th, the date of the contractor's second payment to Koslow. At no time had Shaw and the plaintiff entered into a contract for future deliveries. Nor did the course of business between them reflect a formal contractual relationship. Plaintiff's delivery invoices show a number of deliveries between June 4th and August 25th totaling $33,429.81. These invoices bear the legend: "TERMS: 2%—10 days, 30 NET."

From the facts shown, it is apparent that the plaintiff seeks, as to the first check, to impress a trust upon funds received and paid out by Shaw at a time when there were no job claims outstanding against the contractor. As to the second check, it asserts a trust in excess of claims outstanding against the contractor at the time of the alleged diversion.

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[2] There is no question that the plaintiff fell within the class of "subcontractors, architects, engineers, . . ." etc., described in the statute as beneficiaries of any trust which might arise. For the sake of convenience, this group will be referred to, where necessary, as "job claimants."

Thus, the main question in the case is whether § 36-a creates a trust for the benefit of all potential job claimants or whether, on the contrary, the trust arises only to the extent of unsatisfied, outstanding claims. For reasons stated more fully hereafter, it is held that the statutory trust arises only in the event that there are unpaid claims outstanding and only to the extent of such claims.

The plaintiff may recover nothing in excess of the $321.60 representing the goods delivered prior to Shaw's second payment to Koslow. As to that sum, the evidence established that Shaw's payment to Koslow was a diversion of trust funds concerning which the defendant Koslow had constructive notice. To that extent, therefore, plaintiff's claim to recovery against Koslow is granted. Discussion of the bases for these determinations, as well as of the grounds for sustaining the Court's jurisdiction, follows.

The scope of the limitations imposed by § 36-a on a contractor's freedom to dispose of funds due or received from an owner has not been precisely delineated by the New York Courts. But the nature of the trust was defined by the New York Court of Appeals in *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co.*, 288 N. Y. 452, 43 N. E. 2d 486 (1942). The Court there stated:

> "The statute does not give rise to a fiduciary relationship between a contractor and his subcontractor or, if once created, continue it under any and all contingencies. Whether the moneys in the hands of the contractor are or may be the subject-matter of a trust depends exclusively upon the fact, arising, existing and shifting according to time and circumstance, that the contractor fails to pay the claims mentioned in the section. Nothing in the section bars [their use] for any purpose [the contractor] may see fit provided

> he does not fail to pay all such claims out of other moneys which he may then have or which he may afterwards receive * * * no trust arises * * * from the mere fact that the contractor received and has in his hands moneys in payment on account of a[n] * * * improvement."
> *Supra* at 459.

An earlier opinion, by the Appellate Division, reflects a similar interpretation of the statute. Suit had been brought by a job claimant against a bank to recover the amount of checks received by a contractor on account of an improvement and deposited in its bank account. The bank had applied the money deposited to satisfy the contractor's debts to it. The Court denied recovery on the ground that the bank had had no knowledge, at the time of deposit, that there were any job claims outstanding against the contractor. *Vulcan Rail & Const. Co.* v. *Westchester County*, 250 App. Div. 212, 293 N. Y. S. 945 (2d Dep't 1937).

The clear import of these cases is that no trust arises under §36-a of the Lien Law in the absence of unpaid claims outstanding against the contractor. This analysis accords with the construction of a similar statute by the Supreme Court of Wisconsin. *Danischefsky* v. *Klein-Watson Co.*, 209 Wis. 210, 244 N. W. 772 (1932).[3] The

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[3] See Wis. Stat. Ann. § 289.02 (4) (1953), as amended, 1955. Other states have enacted comparable statutes. See, *e. g.*, Ark. Stat. Ann. § 51-601 (1947); 6 Del. Code Ann. § 3502, 3 (1953); Fla. Stat. Ann. § 84.07 (3) (1941); Ky. Stat. Ann., Baldwin's 1955 Revision, §§ 376.070, 376.990; Mich. Stat. Ann. §§ 26.331-333 (1953); Minn. Stat. Ann. § 514.02 (1945); Rev. Stat. Neb. 52-119 (1943); N. J. Stat. Ann. 2A:44-147 (1952); No. Car. Gen. Stat. § 44-12 (Recompiled 1950); Michie Code of Va. § 43-13 (1953 Replacement); Williams Tenn. Code Ann. §§ 7944a, 7945 (1934); Rev. Code Wash. § 9.54.080 (1951). But the *Danischefsky* opinion is the clearest holding found on the subject.

Wisconsin Court held that in the absence of any outstanding unpaid job claims, the fund had, in the hands of the contractor, the same status it would have had if the trust fund provision had not been enacted. Therefore, county orders on the job were attachable by the contractor's other creditors.

The main challenge to this interpretation of the statute is defendant's contention that the effect of the *Raymond* case was abrogated by subsequent amendment of § 36-a. The statute was amended in 1942. L. 1942, c. 808, §§ 4, 15. The amendments grew out of a conflict of opinion concerning the availability of a civil remedy to enforce the trust. This conflict had been brought to a head by the holding of the Court of Appeals in *Raymond* that the trust created by the statute could not be civilly enforced. *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co., supra,* at 461. Compare *Century Indemnity Co.* v. *Bank of Gowanda,* 35 N. Y. S. 2d 396 (1941), *aff'd,* 263 App. Div. 1068, 35 N. Y. S 2d 463 (4th Dep't), *app. den.,* 264 App. Div. 834, 36 N. Y. S. 2d 417, *reargument den.,* 264 App. Div. 986, 37 N. Y. S. 2d 493, and 265 App. Div. 907, 38 N. Y. S. 2d 318 (1942); *Bray Bros., Inc.* v. *Marine Trust Co. of Buffalo,* 35 N. Y. S. 2d 356 (1937). Also in question was the right of claimants without liens of judgments to pursue the remedy under § 36-a if it were available. See *Wickes Boiler Co., Inc.* v. *Godfrey-Keeler Co., Inc.,* 116 F. 2d 842 (2d Cir. 1940), *rev'd on rehearing,* 121 F. 2d 415, *cert. den.,* 62 S. Ct. 297 (1941). The amendment added the provision for civil enforcement in representative actions by all claimants similarly situated whether or not they had judgments or liens. The earlier language construed by the Court of Appeals was left intact.

The language of the amendment thus evidences no intent to do more than set at rest the controversy expressly recognized in the *Raymond* case. That opinion had al-

ready suggested that the contractor's freedom to deal with his receipts was fettered by the statutory trust provisions of § 36-a only so long as there were existing claimants. The Legislature had not intended, the Court said, "to create a real trust fund to remain such under any and all contingencies from the time the contractor or subcontractor first received payment on account of public or private improvements. . . ." *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co., supra,* at 462. It is reasonable to assume, therefore, that had the Legislature wished further to constrict the contractor's freedom of action, it would have made this intention explicit in the statute. In view of the fact that the architecture of the trust created by § 36-a remains unchanged by statutory amendment, the holding of the *Raymond* case must be regarded as controlling.

The plaintiff has, nevertheless, urged that there is evidence in support of its more sweeping definition of the trust. The *Raymond* opinion intimates that the Court's denial of a civil remedy under § 36-a was based upon its analysis of the nature of the trust. The Court implied that a trust so chameleon-like in character could never lend itself to civil enforcement. And enforcement by the representative action prescribed by the statute of a trust so defined might present difficulties not yet touched upon by the New York courts. Whether, for example, creditors whose claims had arisen after a diversion would be entitled to share equally, upon the contractor's insolvency, in any funds recovered, is problematical. To permit all claimants to share in a trust which had arisen for the benefit of only some of them would be anomalous; and to distinguish among creditors of an insolvent solely upon the basis of the dates when their claims arose would permit fortuitous circumstances to prevail over comparable equities.

A contemporaneous expression of the New York Law Revision Commission is of interest in this connection. Conceding that there was no guiding case law, the Commission expressed the opinion that "even if no * * * claimant existed at the moment of receipt of the moneys by the contractor (or other trustee * * *) a trust would arise in favor of future claimants." Report, New York State Law Revision Comm'n, Leg. Doc. #65, p. 326 (1942). This report, which was begun prior to the Court of Appeals' decision in *Raymond*, suggests that had that case been decided earlier, additional changes in the statute might have been made. But the report does not elaborate on this proposed construction of the trust provision nor suggest its implications. The bare allusion cannot supply the evidence of intent lacking on the face of the statute.

A construction based upon the *Raymond* analysis would appear to effectuate the basic purpose of the Lien Law. The law is intended to assure that laborers and suppliers responsible for the improvement have first claim on the funds attributable to their efforts. Building contracts usually provide for payment in installments proportionate to the estimated value of labor and materials supplied as of a given date. Retained percentage clauses permit the owner to preserve a proportion of the moneys for payments to claimants in case of the contractor's default.[4] Where such provisions are adhered to, the requirement that installments received be held in trust to pay outstanding claims should afford a large measure of security to job claimants. Provision for a continuing trust might afford the additional safeguards needed in situations

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[4] Shaw's contract with Villa-Manor adhered to this general practice. The agreement provided for mid-monthly payments of 95% of the value of labor, materials, etc., incorporated in the work prior to the end of the previous month, less the aggregate of previous payments.

where initial overbidding by contractors prevents full claim satisfaction out of the contract price.[5] But in the absence of indications that the New York courts have recognized such an obligation on the part of contractors, this Court must adhere to its interpretation of the views expressed in the *Raymond* case.

This interpretation does not affect plaintiff's right to recover the $321.60 representing goods delivered prior to the payment to Koslow. Only to that extent, however, may plaintiff's claim against Shaw be enforced against Koslow. The fact that that claim was outstanding at the time of the second payment cannot create a trust in the balance of the funds received from Shaw by the defendant. Even the second payment was a diversion only to the extent that funds were withheld from those rightfully entitled to them at the time. And Koslow, as transferee, may be held liable for the return only of funds paid him in breach of this trust.

Plaintiff's right to recover judgment for $321.60 depends upon whether Koslow took the payments from Shaw with actual or constructive notice that they represented a diversion of trust funds. *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co.*, 288 N. Y. 452, 458-60, 43 N. E. 486 (1942); *Barclay* v. *Corn Exchange Bank Trust Co.*, 267 N. Y. 630, 196 N. E. 615 (1935). The law applicable to recovery of funds diverted under § 36-a is the general law on following trust funds into the hands of third parties. *Century Indemnity Co.* v. *Bank of Gowanda*, 35 N. Y. S. 2d 396 (Sup. Ct., Erie Co., 1941). In order to be held liable for the return of such funds, the transferee must have had notice not only that the funds

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[5] That this problem inspired the passage of measures like § 36-a to supplement the general provisions for mechanics' liens, is indicated by the Report of the Law Revision Commission, Leg. Doc. #65, p. 298ff. (1942).

were subject of a trust, but also that they were transferred in breach of the trustee's duty. Notice of a diversion under § 36-a as interpreted here implies notice of the existence of outstanding claims. *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co., supra; Vulcan Rail & Const. Co.* v. *Westchester County,* 250 App. Div. 212, 293 N. Y. S. 945, 953 (2d Dep't, 1937).

There is no doubt that Koslow knew that the checks paid him by Shaw were "funds received by a contractor for the improvement of real property" within the terms of § 36-a. Drawn by Villa-Manor, the checks were identified on their voucher end as payments on account of the drawer's masonry contract with Shaw. Shaw's credible testimony at the trial, uncontroverted by Koslow, established the latter's familiarity with the contract and its terms.

Koslow may also be charged with notice of the diversion. There was no direct proof of actual knowledge. But he is chargeable with notice if the circumstances were such as to put him on inquiry. *Bischoff* v. *Yorkville Bank,* 218 N. Y. 106 at 111, 112 N. E. 759 (1916); *Bonham* v. *Coe,* 249 App. Div. 428, 292 N. Y. S. 423 (4th Dep't), *aff'd,* 276 N Y. 540 (1937). And the facts within his knowledge at the time of the payment on June 4th, placed him under a duty of inquiry as to the existence of any outstanding unpaid claims against Shaw. The circumstances are distinguishable from situations in which courts have refused to recognize a duty to inquire. Koslow was not in the position of a bank, dealing at arms length with a borrower. See *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co., supra; Clarke* v. *Public Nat. Bank & Trust Co. of New York,* 259 N. Y. 285, 181 N. E. 574 (1932). His own testimony established a close and friendly relationship between him and Shaw which had grown out of previous dealings between them. On prior occasions, as in

the present case, Koslow had given Shaw short-term loans at rates left entirely to the discretion of the lender. In the instant case, he extended credit of no more than $7,600 and as little as $4,600 for less than two weeks at a charge of $500.[6] The circumstances thus suggest a financial emergency of which Koslow could not have failed to take cognizance. Further inquiry should have followed as a matter of course. Recognition that such a duty might be unduly burdensome to banks or other large agencies cannot detract from the obligations of one who deals familiarly with a personal acquaintance. Nor can it seriously be maintained that such inquiry would have been to no avail. Merely by checking with persons working on the job Koslow could have identified Shaw's sources of supply and through them procured such information, if any, as might have been withheld by the contractor. Having failed to make such inquiries, he is chargeable with notice of the facts they would have disclosed.

Defendant raised an additional defense to plaintiff's claim for return of the trust funds. Koslow alleged that the money he loaned to Shaw had been applied by the contractor to the Villa-Manor payroll. And he maintained that since the moneys advanced by him were used for the Villa-Manor payroll (*i. e.*, for "trust purposes"), he was entitled to be repaid notwithstanding unpaid job claims. This contention was unsupported by proof. Shaw was unable to say how much, if any of the money borrowed from Koslow had been applied to the Villa-Manor job. Nor had he any books or records showing the

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[6] Shaw borrowed $7,600 on June 21st, $3,000 of which he repaid on the 28th. On June 3rd he borrowed an additional $2,800, but the whole debt was extinguished by his second payment to Koslow on the 4th. The additional $1,500 sued for represents the finance charge and $1,000 returned by Koslow in cash on the 4th.

allocation of his receipts among his various jobs. Thus, in view of the failure of proof, it is unnecessary to rule on the defendant's contention.

Assuming, *arguendo*, however, that proof were adduced, Shaw's use of the borrowed money to pay other job claimants would not, in my opinion, have been a legal defense to this action. Section 36-a impresses a trust for claimants of a designated class. The trust exists as long as any of such claimants are unpaid. Defendant was not a claimant of the class described. The fact that his loan had been used to satisfy some of such claimants could neither place him in their shoes nor give him preference over those still unpaid.

Protection for creditors in Koslow's alleged position is provided for elsewhere in the Lien Law. Section 13 (1-a) defines the rights of creditors advancing money for use on building jobs. Lien Law § 13(1-a), as added, L. 1942, c. 808, § 13. By taking and filing an assignment incorporating a trust covenant, the creditor may obtain a lien to the extent of moneys applied to the job. Koslow failed to avail himself of this source of protection. To permit him to prevail over the beneficiary of the trust fund would reward his neglect with preferment beyond that accorded for full compliance with the statute. Having eschewed the protection conferred, he may not claim a right reserved to others. See *Century Indemnity Co.* v. *Bank of Gowanda*, 35 N. Y. S. 2d 396 (Sup. Ct. Erie Co., 1941); *contra, Bray Bros.* v. *Marine Trust Co.*, 35 N. Y. S. 2d 356 (1937).

Before concluding, however, it is necessary to allude briefly to the reasons why defendant's jurisdictional motions could not be sustained. The Court's jurisdiction hinged upon the conclusion that A. Shaw & Co., Inc. was not an indispensable party to this action. Unless Shaw was indispensable, the Court was authorized to grant the

plaintiff's motion to sever the action against the contractor and proceed to the merits as between the plaintiff and Koslow. *Wells* v. *Universal Pictures Co.*, 166 F. 2d 690 (2d Cir., 1948).

Shaw would have been indispensable only had it had some interest in the subject of the action which might have been inequitably affected by the disposition of the case against Koslow. Here, having parted with the checks in suit, it stood to lose nothing by the determination in this case. It was not in the position of a trustee who, as legal titleholder or guardian of the rights of absent beneficiaries, retains an interest in the disposition of diverted funds. *Cf. Backer* v. *Levy*, 82 F. 2d 270 (2d Cir., 1936); *Cherry* v. *Howell*, 66 F. 2d 713 (2d Cir., 1933). While the contractor is a trustee under the terms of § 36-a of the Lien Law, enforcement of the beneficial interests is specifically entrusted to the *cestui que* trust. And protection of all claimants beneficially interested is assured by the statutory requirement of a representative action. Lien Law §§ 316a, 71. Thus Shaw's position was analogous to that of a debtor in an action by his creditor to set aside a fraudulent conveyance. The debtor is not indispensable in such an action. *Keene et al.* v. *Hale-Halsell Co.*, 118 F. 2d 332 (5th Cir., 1940); *Keaton* v. *Little*, 34 F. 2d 396 (10th Cir., 1929); *Allan* v. *Moline Plow Co.*, 14 F. 2d 912 (8th Cir., 1926). Regardless of the outcome, he neither acquires nor loses any rights in the property conveyed. He cannot be prejudiced by a decree which subjects his former property to the payment of his debts. *Allan* v. *Moline Plow Co., supra.*

Defendant also argues that since diversion of funds by a contractor is punishable as larceny under § 36-a, a finding in the absence of the contractor and its officers that the funds in issue were diverted would be an unconscionable assault upon their reputations. Parties necessary

under the Federal Rules, however, are parties jointly interested in the subject of the action. Fed. R. of Civ. P. 19. As already indicated, no such interest exists here. Nor is it apparent that the determination in this action will have the unfortunate effects claimed. The contractor himself has evidenced no concern with the specter raised by defendant Koslow. He could have appeared, but he chose instead to default. Called to testify on Koslow's behalf, he appeared with his counsel and he proved to be a willing witness. Under the circumstances, there is no injustice in permitting the trial of this action without the presence of Shaw as a party.

Plaintiff is entitled to judgment against the defendant for $321.60.

Dated: March 29, 1956

EDMUND L. PALMIERI,
Edmund L. Palmieri,
U. S. D. J.

Judgment entered:

WILLIAM V. CONNELL,
4-3-56. Clerk

APR 29
JOHN T. FEY

IN THE

Supreme Court of the United States

October Term, 1956

No. 877

GRAMATAN-SULLIVAN, INC.,

Petitioner,

—against—

NATHAN KOSLOW,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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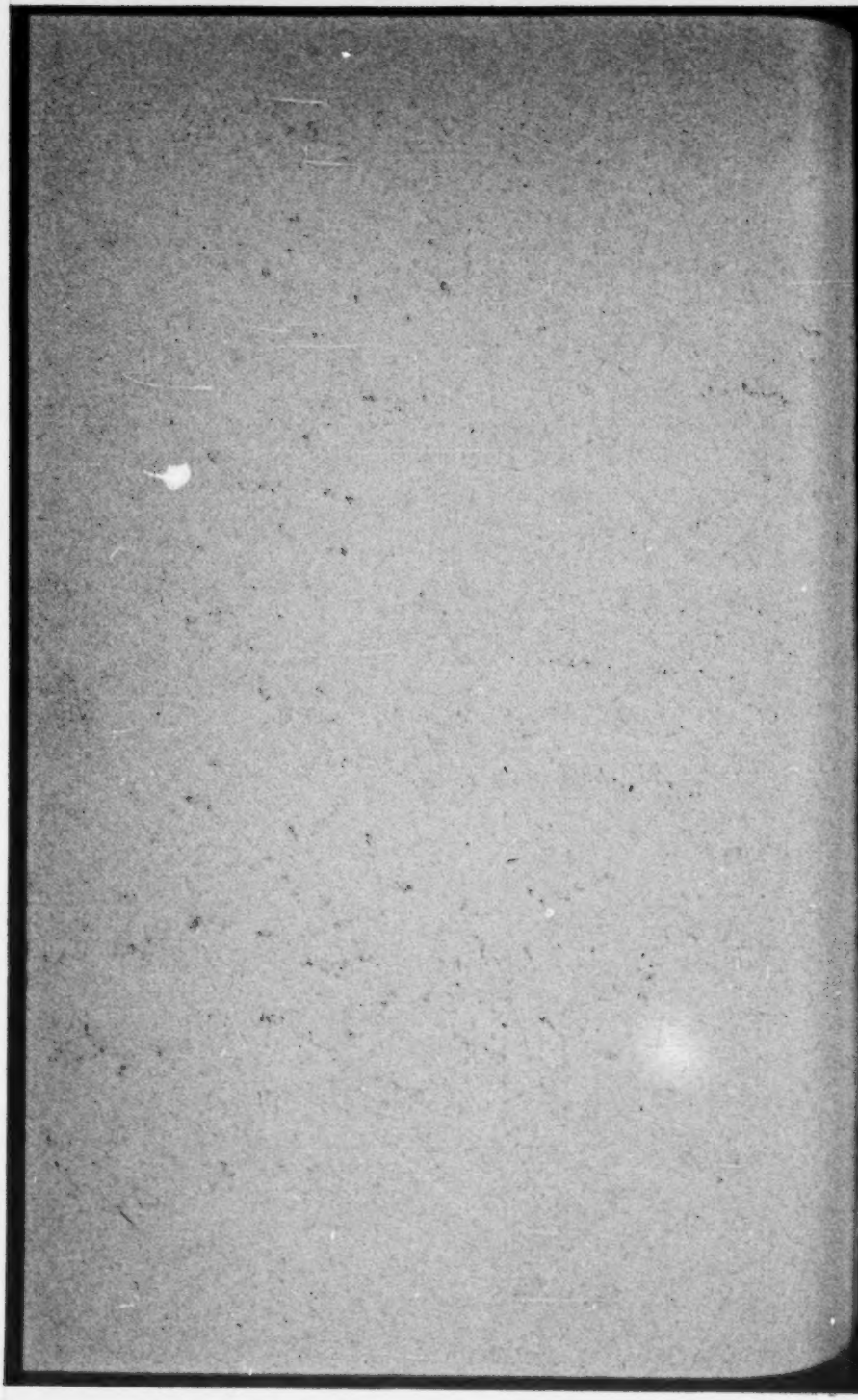

INDEX

PAGE

Statement 1
The Facts 2
Argument 7

(1)

There was a complete failure of proof on the two points which petitioner was required to establish to make out a case, namely (1) that Koslow had notice or knowledge that the checks delivered to and accepted by him were for a trust purpose; and (2) that his acceptance and use of the checks constituted a diversion from a trust purpose 7

(2)

Effect of the Amendment of Section 36-a of the Lien Law in 1942 17

Conclusion 22

DARK PAGE BLEED THRU

INDEX—(*Continued*)

TABLE OF AUTHORITIES CITED

CASES:

Bischoff v. *Yorkville Bank*, 218 N. Y. 106, 111..... 10

Clarke v. *Public National Bank & Trust Co.*, 259 N. Y. 285 9

Commonwealth v. *Hartnett*, 3 Gray 450..... 18

Danischefsky v. *Klein-Watson Co.*, 209 Wis. 210..... 15

New York Trap Rock Corp. v. *National Bank of Far Rockaway*, 285 N. Y. 825..... 10

Pulitzer v. *City of New York*, 48 App. Div. 6, 10..... 18

Raymond Concrete Pile Co. v. *Federation Bank & Trust Co.*, 288 N. Y. 452.....10, 13, 17, 18, 19, 20

Vulcan Rail & Construction Co. v. *County of Westchester*, 250 App. Div. 212.....8, 16

DARK PAGE BL

INDEX—(Continued)

STATUTES, ETC.

PAGE

Lien Law—
Section 25-a 9, 10, 11, 17
Section 36-a 1, 2, 8, 10, 17, 18, 20, 21
Section 71 1

Real Property Law—
Section 233 19

ED THRU

DARK PAGE BLEED

IN THE

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October Term, 1956

No. .....

GRAMATAN-SULLIVAN, INC.,

Petitioner,

—against—

NATHAN KOSLOW,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Statement

In an action wherein the plaintiff (petitioner herein) asked judgment (under Sections 36-a and 71 of the Lien Law of the State of New York) declaring that the defendant (respondent herein) holds the proceeds of two certain checks in the amounts of $3,000 and $8,900 respectively, as a trustee, a judgment was entered in the office of the Clerk of the District Court for the Southern District of New York, on April 3, 1956, after a trial before Hon. Edmund L. Palmieri, District Judge, without a jury, in favor of the plaintiff and against said defendant in the sum of $321.60.

THRU

The plaintiff (petitioner) appealed to the United States Court of Appeals for the Second Circuit from so much of the said judgment as determined (1) that the plaintiff's right to pursue alleged diverted lien funds herein under the aforesaid sections of the Lien Law, was limited to the said sum of $321.60; (2) that under Section 36-a of the Lien Law, a statutory trust was created only to the extent that there were unpaid outstanding claims at the time of the alleged diversion; and (3) that the provisions of said Section 36-a do not purport to create a real trust fund to remain such under any and all contingencies until all job creditors have been paid. Defendant did not appeal from the judgment.

The judgment was affirmed on January 7, 1957, in an opinion by Judge Hand, wherein Judge Swan concurred, and a dissenting opinion by Chief Judge Clark.

The primary question presented herein is with respect to the correctness of the construction placed by the Courts below upon Section 36-a of Lien Law of the State of New York. The said section is printed in full on pages 2 and 3 of the petition herein.

In order that the questions of which petitioner seeks a review may be fully presented, a more complete statement of the facts than appears in the petition is essential.

The Facts

On or about April 25, 1954, a corporation A. Shaw & Co., Inc. (sometimes referred to herein as "Shaw") entered into a contract in writing with Villa-Manor Realty Co., Inc., (hereinafter termed "Villa-Manor") to furnish all labor and material needed for the *masonry work* upon a private improvement at Dobbs Ferry, New York, which the said Villa-Manor had then undertaken.

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The contract price was $141,000; and it was provided that payments thereon up to 80 per cent of the work completed (later changed to 95 per cent) were to be made between the 15th and 20th of each month.

Arthur F. Shaw (the president and alter ego of A. Shaw & Co., Inc.) called as a witness for the defendant, testified that the Shaw corporation never completed its contract. Work continued until about the end of August, 1954, when the contract had become unprofitable to such an extent that Shaw could not continue further and thereupon ceased work.

The work was then (according to Shaw) substantially completed. They never received the $141,000—up to the time they ceased work they had received approximately $130,000; all disbursements from the moneys received were made by Shaw personally; he was familiar with what happened to every dollar received from Villa-Manor; they had used the money to pay payroll and job creditors.

While this work was progressing Shaw had altogether three jobs under way in New York State; besides the Villa-Manor contract they were working on Dalewood Gardens at Scarsdale; and a job on 87th Street, in New York City; all of these operations were the work of the Shaw corporation.

Shaw testified that one exception where moneys received from Villa-Manor did not go in the first instance into the Villa-Manor job was on one occasion when money was needed for the Dalewood Gardens payroll; Shaw tried (with the aid of Mr. Paterno, the president of Villa-Manor) to get the Dalewood owner to advance the needed money—but Dalewood would not provide the money until a payment on its own building loan on the Dalewood

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property had become due and was paid; thereupon Paterno (Villa-Manor) gave Shaw the needed money (about $7,000) with which Shaw met the Dalewood payroll; that $7,000 was later restored to the Villa-Manor job and was used to pay Villa-Manor expenses—it went back into the Villa-Manor job; other than that, every cent received from Villa-Manor went into the Villa-Manor job.

Shaw's first payroll on the Villa-Manor job was for the week ending May 12, 1954; the gross payroll beginning with that week to and including the week ending June 9, was $10,466.82.

Although by the time Shaw gave up and abandoned the contract, they had received and paid out approximately $130,000, there then remained a balance unpaid for materials supplied of about $42,000; that was because (as Shaw said) they had "figured a low figure and it went way above what it should have been."

Shaw further testified that on May 21, 1954, he needed money for the payroll; on that day he met the defendant Koslow (with whom he had had prior loan transactions) and asked him to advance money for the payroll. Koslow testified that Shaw told him he was expecting a payroll check any day.

Shaw's testimony is that in prior transactions he had borrowed moneys from Koslow or "C. N. K. Co.", a trade name under which Koslow did business; in those prior transactions Shaw took the money borrowed from Koslow and deposited it in the bank account of A. Shaw & Co., Inc.—he had used some of that money in connection with the Villa-Manor job.

On May 21, 1954, Koslow gave Shaw (upon his said request for money for the payroll) a check drawn by C. N. K. Co., dated May 21, 1954, in the sum of $7,600.

DARK PAGE BL

That check was deposited in the bank account of A. Shaw & Co., Inc.; and the money was used (as Shaw testified) for payroll and also for supplies.

On May 28, 1954, Shaw received from Villa-Manor the first check for work on that job in the sum of $3,000; it was drawn to the order of "A. Shaw & Co., (not "Inc.") and was so endorsed and delivered to Koslow to be applied on account of the $7,600 advanced; that check was deposited by Koslow in his C. N. K. Co. account.

On June 3, 1954, Shaw asked Koslow to advance an additional sum of $2,800 towards the payroll; and a check for $2,800, dated June 3, 1954, drawn by C. N. K. Co., was delivered to Shaw and deposited in the A. Shaw & Co., Inc., account.

On June 4, 1954, a Villa-Manor check for $8,900 to the order of "A. Shaw & Co." was turned over to Koslow; and was deposited in the C. N. K. Co. account.

Shaw had thus received from Koslow in this transaction the two checks of $7,600 and $2,800, a total of $10,400; while Shaw had turned over to Koslow the two Villa-Manor checks of $3,000 and $8,900, a total of $11,900. There was, therefore, a difference in favor of Shaw of $1,500. Accordingly, on June 22, 1954, Koslow gave Shaw, on account of this difference, a check, drawn by C. N. K. Co., for $1,000 (which was deposited in the account of A. Shaw & Co., Inc.); and the remaining $500 was absorbed, by mutual agreement, as a finance charge. The transaction between Shaw and Koslow was thereby closed.

Shaw testified that during the month of May, 1954, they were at work on the masonry contract (as evidenced, for one thing, by the payrolls above referred to); they had to spend money for labor and materials; be-

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fore starting the masonry operations they had to buy a substantial amount of lumber—it was a big job; in May, 1954, Shaw received no moneys from Villa-Manor (on the Villa-Manor Job) except the $3,000 check, dated May 28, 1954, which was endorsed and delivered to Koslow. There was another Villa-Manor check, dated May 28, 1954, for $3,000, to the order of A. Shaw & Co.; that check was cashed at Villa-Manor's bank and the whole amount thereof was turned over to Vincent Paterno (of Villa-Manor) who told Shaw that it was to be held for *advertising* and such—in any event the proceeds were not received by Shaw. A further check of Villa-Manor in the amount of $12,000 was delivered to Shaw on June 4, 1954, on account of the Villa-Manor job; but that check in no way entered into the Shaw-Koslow transaction.

Shaw had received no advance from Villa-Manor at the time of starting the job; A. Shaw & Co., Inc., had a small balance of its own for the purpose of starting this job; of necessity they had to borrow money from the outside to meet the labor and material cost; when Shaw needed money, he said he got it wherever he could and put it in to keep the company going—witness, the $3,000 Millard Estates (New Jersey) check deposited in the Shaw Corporation account; the Shaw enterprise was not in good financial condition—they were unable to meet current obligations without borrowing.

They were (as Shaw testified) pushing the work on the Villa-Manor job, figuring that in that way they could get their money, pay off what was owing, and get a profit; but pushing the work involved putting on more bricklayers and laborers with increased cost; they found they could not keep it up; and ultimately they had to cease work.

Shaw said that he knew there was an outstanding

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indebtedness to plaintiff (petitioner) for unpaid building materials supplied during *May* and June, but so far as the month of *May* is concerned, this statement is in error, for the proof shows no deliveries by plaintiff during May; plaintiff's delivery invoices show deliveries on June 1st, 2nd and 4th; the invoices recite "Terms: 2%—10 days, 30 net"—so that even on the first deliveries on June 1, Shaw had 30 days to pay, and there was no past due indebtedness to plaintiff until the expiration of that period.

Whatever view be taken of Shaw's method of doing business—which he admitted was "handled rather slipshod"—manifestly the proof affords no basis upon which any claim by plaintiff against Koslow can be sustained.

ARGUMENT

There was a complete failure of proof on the two points which petitioner was required to establish to make out a case, namely (1) that Koslow had notice or knowledge that the checks delivered to and accepted by him were for a trust purpose; and (2) that his acceptance and use of the checks constituted a diversion from a trust purpose.

(1)

There is no dispute that at common law no trust or fiduciary relationship arose or existed between a contractor and his subcontractor.

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It is, however, the petitioner's contention that by the statute (Section 36-a of the Lien Law) with the amendment thereto and the decisions based thereon, the right of the contractor, with respect to moneys received from the owner of real property, has been so limited and circumscribed that the contractor holds such moneys upon *a real and absolute trust* (effective at all times and in any and all contingencies) for subcontractors (or others specified in the statute) as long as they have outstanding and unpaid claims.

Examination and analysis of the statute, the amendment thereto, and the interpretation which the courts of the State of New York (including the highest court of the State, the Court of Appeals), have placed thereon, do not bear out the petitioner's contention in this regard.

Section 36-a of the Lien Law, as it was first enacted in 1930, provided in substance that the funds received by a contractor "from an owner for the improvement of real property" were trust funds in the hands of the contractor to be applied first to the payment of specified creditors under the contract; and that any contractor who diverted such funds from such trust purpose was guilty of larceny.

The earliest appellate court decision having to do with the meaning and scope of Section 36-a is apparently *Vulcan Rail & Construction Co.* v. *County of Westchester*, 250 App. Div., 212, where it appeared that one Farley (through a corporation consisting of himself and his wife) had obtained a contract for a public improvement in Westchester County; in that connection Farley obtained extensive loans from the Tarrytown Bank & Trust Company—it appeared that some of the moneys advanced by the bank were used by Farley to meet payments due on other contracts upon which the Farley corporation was then engaged; and the second cause of

action set forth in the complaint was against the bank for alleged diversion to it of moneys received by the contractor under the original contract. It appeared that at the time of the transaction complained of, the statute had not been extended (by Section 25-a of the Lien Law) to public improvements. In dismissing for that reason the second cause of action, Mr. Justice (later Presiding Justice) Close, writing for the Appellate Division, said:

> "The dismissal of the claims against the bank was also correct for another reason. Even if Section 36-a did apply, it imposes a trust upon the fund only, 'in the hands of such Contractor.' The bank would not be liable unless it participated knowingly in a diversion of the fund. The official referee found, upon ample evidence, that *the bank had no knowledge of any claims on the part of laborers, materialmen or others mentioned in the statute.* Consequently it had no knowledge that the moneys received from the county were trust funds, and it could not have been aware of any misappropriation. In such circumstances there is no liability on the part of the bank. (*Clarke* v. *Public National Bank & Trust Co.*, 259 N. Y. 285)." (Italics added.)

In the *Clarke* case (*supra*), cited by Close, J., it appeared that one Louis Rosenhaus, the committee for an incompetent, deposited checks payable to "Louis Rosenhaus, Committee for David Rosenhaus" in his individual account in the defendant bank. The successor committee brought an action against the bank, on the ground that the bank aided the committee to appropriate moneys to his own use. It was *held* that the deposit by the fiduciary of trust funds in his individual account did not constitute a conversion thereof—*the bank had the right*

to presume that the fiduciary would apply the funds to their proper purpose (*Bischoff* v. *Yorkville Bank,* 218 N. Y. 106, 111)—to hold the bank (it was said) there must be proof that the original committee did not apply the funds "to their proper purpose under the trust"; and that the defendant bank not only had notice or knowledge that moneys were received for a trust purpose but also that they were diverted from that purpose—in that respect the proofs on behalf of the plaintiff were wholly insufficient.

The instant case is stronger for the defendant-respondent than the case last cited, for here there is proof that the funds advanced by Koslow were applied to a proper purpose, namely, for the payrolls and the essential materials upon the Villa-Manor job.

In *New York Trap Rock Corp.* v. *National Bank of Far Rockaway,* 285 N. Y. 825 (cited on pages 8-9 of the petition herein) the plaintiff had furnished materials to a contractor on a grade crossing elimination project; the contractor received the final payment of $38,000 and deposited the money in the defendant bank; the bank applied the proceeds to the contractor's indebtedness to the bank; plaintiff brought an action at law to recover his loss, claiming that under Section 25-a of the Lien Law (identical with Section 36-a, except that the remedy was thereby extended to public improvements) the amount deposited was a trust fund— the Court there held that an action at *law* could not be maintained, leaving open the question whether relief could be had in a representaive action.

That question was before the Court of Appeals in *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co.,* 288 N. Y. 452,* where plaintiff had performed work

*Upon reargument the Court adhered to its original decision, 290 N. Y. 611.

and furnished materials upon the new Criminal Courts Building, in the City and County of New York. The contractor was indebted to the defendant bank in a large amount upon notes, the proceeds of which were deposited in the contractor's account in the bank and were "used by contractor for the purpose of the contract." (p. 456). Subsequently the contractor received the City's warrant and order for a sum largely in excess of the contractor's indebtedness to the bank; the contractor deposited the warrant in his account in defendant bank, which collected the same and applied the proceeds so far as necessary as an offset and payment of the contractor's indebtedness. Thereafter, the plaintiff's claim not having been paid, it brought a representative action against the bank, on the ground that the moneys represented by the warrant were trust moneys, under Section 25-a of the Lien Law. There was no evidence whether the bank ever made any inquiry to determine if there were in existence any beneficiaries of the fund when the offset was made.

The Court of Appeals unanimously reversed a judgment in favor of the plaintiff, in an opinion by Rippey, J., wherein it was said that where a bank knows that a refund deposited with it is a trust fund it cannot appropriate that fund for its private benefit:

> "But one who relies upon the application of those principles must *always* affirmatively establish that the bank had notice or knowledge not only that the moneys on deposit were for a trust purpose but also that they were diverted from that purpose (*Clarke* v. *Public Nat. Bank & Trust Co.*, 259 N. Y. 285; *American Lumberman's Mutual Casualty Co.* v. *Bradley Construction Co.*, 129 N. J. Eq. 278)." (Italics added.)

The Court further said, of the change made by the statute from the rule at common law, (at p. 459):

> "The most that the statute does or was designed to do in that respect is to create the possibility of a fiduciary relationship arising between the contractor as to funds coming into his hands from a public improvement contract and a possible sub-contractor or possibly others designated. The statute does not give rise to a fiduciary relationship between a contractor and his subcontractor or, if once created, continue it under any and all contingencies. Whether the moneys in the hands of the contractor are or may be the subject-matter of a trust depends exclusively upon the fact, *arising, existing and shifting according to time and circumstances,* that the contractor fails to pay the claims mentioned in the section." (Italics added.)

The Court of Appeals said that

> "*nothing in the section bars the contractor from using the moneys received for any purpose he may see fit provided he does not fail to pay all such claims out of other moneys which he may then have or which he may afterwards receive;* and nothing in the section bars a banker from applying moneys, if on deposit in the contractor's account at the bank, without inquiry, upon the contractor's indebtedness to the bank. It necessarily follows that no trust arises under that section from the mere fact that the contractor received and has in his hands moneys in payment on account of a public improvement." (Italics added.)

The Court further added (at p. 459):

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> "There is no evidence in the case to indicate that the defendant knew or had any reasonable grounds to suspect prior to February 23, 1939, either that the plaintiff was a sub-contractor in connection with such improvement work or that it had any claim at any time for work, labor and services performed or materials furnished in connection therewith or that any other person referred to in Section 25-a of the Lien Law had any such claim. *Without such evidence, there was no basis in the record for the judgment requiring defendant to return the moneys which it received in payment of the obligation of the contractor* (*Clarke* v. *Public Nat. Bank & Trust Co., sunpra*)." (Italics added.)

The language quoted throughout the opinion in *Raymond Concrete Pile Co.*, v. *Federation Bank & Trust Co., supra,* aptly applies to the case at bar. The evidence here is that the contractor Shaw came to Koslow on May 21, 1954, and asked for a loan to enable him to meet his payroll—Shaw told Koslow that any day he expected a check to cover the payroll. This occurred at an early stage in the performance of the Shaw contract—for there had been at that time no moneys due or payable from the owner of the improvement.

It was for that reason that Shaw had to borrow as a temporary expedient to tide him over the few days interval until the contract payment would be received. Of necessity Shaw had to borrow money from outside sources to meet his payroll and the cost of supplies—he had no other available source.

That the moneys from Koslow were largely used for payroll is inferrable from the fact that Koslow ad-

vanced in all $10,400, while the payroll for the weeks up to and including the week ending June 2nd, 1954, was $7,390.75—leaving a balance for supplies, including the large amount of lumber to which Shaw testified.

The loans having been made for the needs of the job (and so applied) it was entirely proper for Shaw to repay them out of moneys received shortly thereafter on the job from Villa-Manor.

It was said by Palmieri, D.J., in his opinion in the District Court, that Koslow, at the time he received the checks knew that they came from Villa-Manor—that the checks themselves, on the voucher part, evidenced that fact. There is, of course, no question that the checks came from the Villa-Manor job, and that Koslow was aware thereof. Both Shaw and Koslow testified that Shaw asked for the loan for payroll purposes—it was the payroll on the job upon which Shaw was then engaged.

It was further said in the opinion of Palmieri, D.J., that at the time Koslow took the second check there were job claims outstanding, for materials delivered at the job by plaintiff in the amount of $321.60—but in this the Court was plainly in error.

There were then no unpaid amounts for *labor*—for the reason that all the payrolls had been met, mainly through the moneys advanced by Koslow. As to plaintiff's deliveries of *materials*, the only deliveries prior to the acceptance of the second check to Koslow on June 4, 1954, were on June 1st, 2nd and 4th. The invoices for those deliveries bear the legend: "Terms: 2%—10 days, 30 net." There was, therefore, *no unpaid claim* for deliveries until the 30-day period had elapsed from the date of the first delivery, June 1, 1954.

If there were no unpaid and outstanding claims (of

any character) at the date of Koslow's acceptance of the second check, there was no diversion of any trust funds —even assuming there was an existing trust—*of which there was no sufficient evidence herein.*

Such was the holding in the decision of the Supreme Court of Wisconsin (with reference to the construction of a similar statute) in the case of *Danischefsky* v. *Klein-Watson Co.*, 209 Wis. 210, cited by the District Judge herein. In that case the Wisconsin Supreme Court held that in the absence of any outstanding job claims, the fund had, in the hands of the contractor, the *same status that it would have had if the trust fund provision had not been enacted.* Such is the situation presented in the instant case.

It was said, in the brief of the plaintiff-appellant in the Court below (referring to scattered, disconnected fragments of testimony therein) that with a job starting in May, with the first payment to come from the owner on June 15th, "it must be a matter of *judicial knowledge*" that there must have been job creditors "even if limited to workmen and compensation insurance carriers". The statement has no basis in the proof, so far as concerns workmen, for the proof is that the payrolls were met each week (for the most part with Koslow's moneys); and there is no proof of any accrued or past due items of compensation insurance. The plaintiff-appellant herein was manifestly straining the doctrine of judicial notice far beyond its permissible limits.

The procedure of a contractor borrowing money upon notes (as a temporary expedient to advance the work in progress) is not unusual—Shaw had taken advantage of it with Koslow on prior occasions—it was doubtless to Shaw's advantage to have available a source of ready

money. Like many another contractor Shaw had to borrow money to meet current obligations—which money (the testimony shows) went into the improvement herein—surely there was nothing objectionable or wrong in that.

It was further said in the opinion in the District Court that on June 4th, when Koslow received the second check, he should have made inquiry for any outstanding claims; but the proof is that at that early stage of the improvement, there were no claims or job claimants—not even of the plaintiff who had first delivered materials on June 1st upon the invoice giving the contractor 30 days (to June 30th) to make payment—when there were no job claimants, inquiry would, of course, have been uncalled for and unavailing.

It was said, in the brief of plaintiff-appellant in the Court below, that the statute by its terms must be given a liberal construction; but as was pointed out by Judge Close in his opinion in the *Vulcan Rail* case, *supra,* (at page 218) "liberal construction" does not mean that the Court has power to make an amendment which the Legislature has not seen fit to make.

The result of the petitioner's contention herein, (carried to its logical conclusion) would be that Koslow (though he advanced his money in good faith for the purposes of the improvement at a time when there was no trust, and though the moneys went into the improvement, and though he was repaid by the contractor at a time when there was no trust and no diversion) would be caused to lose all the money he advanced, with a further sum in addition thereto. Nothing in the evidence herein affords any basis for such an unjust result.

(2)

Effect of the Amendment of Section 36-a of the Lien Law in 1942

Petitioner contends that whatever view be taken of the decision in *Raymond Concrete Pile Co.* v. *Federation Bank & Trust Co., supra,* its effect has been nullified by the amendment to Section 36-a of the Lien Law in 1942.

The Court of Appeals, in its opinion in the *Raymond* case, decided that *no real or true trust* arose by reason of Section 36-a (similar in all material respects to Section 25-a, then before the Court); that the most that the section accomplished was to create the *possibility* of a fiduciary relationship under circumstances outlined in the opinion; and it was further held that the purpose of the section was "solely penal and not to provide civil remedies"—that the civil action then before the Court must be dismissed.

It was to make available a civil remedy (where a trust *might* exist under the circumstances outlined in the *Raymond* case) that the amendment was, for one reason, enacted. Another reason was that in some cases doubt had been expressed whether a creditor, in order to take advantage of the section, must have filed a lien or recovered a judgment. The amendment added, therefore, to the section in its original form, that the trust therein referred to might be enforced in a representative civil action by any person entitled to share in the fund, whether or not he had filed, or had the right to file a lien, or had recovered a judgment; and to remove a further possible doubt the amendment provided that the trust fund

included moneys due, or to become due to the contractor as well as moneys actually received by him.

With these additions (as was said by Judge Hand in his opinion in the Court below) Section 36-a was re-enacted by the amendment *word for word*, in its original form. The trust which might possibly arise under Section 36-a herein is no different, therefore, from that before the Court in the *Raymond* case—only as to the remedy afforded, the right of a non-lien creditor to start the action, and the subject matter of the possible trust fund, does the amendment add anything to the statute as it was at the time of the *Raymond* decision.

The rule to be applied where in an amendment the original statute is re-enacted *in the same terms* has been frequently stated. Thus, in *Pulitzer* v. *City of New York*, 48 App. Div. 6, 10, it was said (quoting from *Commonwealth* v. *Hartnett*, 3 Gray 450):

> "When the same Legislature in a later statute uses the terms of an earlier one which has received a judicial construction, that construction is to be given to the later statute. And this is manifestly right. For if it were intended to exclude any known construction of a previous statute, the legal presumption is that its terms would be so changed as to effect that intention."

What was said in the concluding part of the last quotation applies with special force to the instant case.

Petitioner contends (as was said in its brief in the Court below) that since its amendment Section 36-a requires that both the monthly payments and the retained percentages constitute "*a reservoir*" to be maintained, "so far as the moneys permitted" (though just what

that means is not clear) until the last job creditor has been paid. If petitioner intends (by the language thus used) that the funds as received by the contractor must be set aside and maintained as a real or true trust, it is wholly contrary to the interpretation placed upon exactly the same terms in the *Raymond* case. As was said by Judge Rippey in his opinion in that case (at p. 462):

> "In clear terms those sections were not intended to create a real trust fund to remain such under any and all contingencies from the time the contractor or sub-contractor first received payment on account of the public or private improvements respectively."

The plaintiff-appellant (in its brief below) apparently sought to have the Court hold that all moneys received by the contractor from the owner must be set aside and deposited in a separate trust fund to be drawn down only to pay job creditors. If that were the intention the Legislature could readily have said so in the amendment—as where it provided in Section 233 of the Real Property Law (as to moneys deposited by a tenant with the landlord as security for the performance of his contract) that the moneys shall be held in trust by the person with whom the deposit is made, and *shall not be mingled* with the personal moneys of the person receiving the deposit.

The Legislature made no similar enactment with respect to moneys received by a contractor from the owner —and for a good and sufficient reason.

If a contractor were to be bound by any such restriction or limitation upon his use of the moneys (as petitioner insists upon), it would mean that not infrequently

a contractor would be unable to proceed with the improvement.

The contractor must work (as to moneys received from the owner) and the Legislature intended that he should so work, subject only to the limitation set forth in the opinion of Judge Rippey in the *Raymond* case, where he said (at p. 459):

> "Nothing in the section bars the contractor from using the moneys received for any purpose he may see fit provided he does not fail to pay all such claims out of other moneys which he may then have or which he may afterwards receive; and nothing in the section bars a banker from applying moneys, if on deposit in the contractor's account at the bank, without inquiry, upon the contractor's indebtedness to the bank. It necessarily follows that no trust arises under that section from the mere fact that the contractor received and has in his hands moneys in payment on account of a public improvement."

In the instant case (as above pointed out) none of the elements necessary to show the creation or diversion of a trust under Section 36-a was established by the plaintiff's proofs.

The dissenting opinion of Chief Judge Clark herein dwells at length upon the report of the Law Revision Commission of the State of New York, which preceded the amendment in 1942 of Section 36-a.

The findings of the learned Law Revision Commission are, of course, entitled to great respect; but it is only

so far as its recommendations were approved and enacted into legislation that they require consideration herein.

Among the recommendations of the Commission were (1) that the relief provided for in Section 36-a should be extended to include a representative civil action; and (2) that a claimant (to have the advantage of the section) need not be a lien or judgment creditor. Both of these recommendations were approved and adopted by the Legislature; and became, by amendment, part of Section 36-a.

The further recommendation of the Commission (which is stressed in the dissenting opinion herein) namely, that the trust created by Section 36-a should be in effect an absolute trust whereby the use by the contractor of moneys received from the owner should be strictly limited to the purposes designated in the section, and none other, did not meet the sanction and approval of the Legislature. It was manifestly deemed inadvisable (for the reasons hereinabove set forth) so far to curtail the contractor's activities as to interfere with and possibly prevent the legitimate conduct and completion of his business.

CONCLUSION

The petition herein presents a question of State policy which has been enacted into the statute law of the State of New York. The statute has been the subject of definitive interpretation and construction by the highest Court of the State. If its scope and purpose are to be further extended, it is (as was said in the prevailing opinion below) a matter for legislative, and not judicial, amendment.

No sufficient reason is shown for certiorari herein and the application therefore should be denied.

Respectfully submitted,

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Counsel for Respondent.

April 20, 1957.